Morgan Stanley | RESEARCH

UPDATE

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Global Interest Rate Strategist

In Love with the Shape of You

We remain neutral on duration in global rates markets as do our BMI(10) models. Instead, we focus on the shapes of yield curves. We think the US Treasury and JGB curves will continue to flatten while intermediate-sector Germany will outperform. The long wait for reflation is getting longer.

Duration and Curves

In the US, we continue to suggest UST 2s30s flatteners, though we are on alert for chances to lighten up ahead of October CPI. In the euro area, we suggest staying long 5y German on the curve, and also staying long Italy/Spain vs. Germany/France. In the UK, we remain neutral on duration and curve. In Japan, we continue to suggest JGB 20s40s flatteners, and favor JPY swaps over JGBs for expressing long-duration views.

Sovereigns

In the US, we examine the main points made in the Treasury refunding statement. We continue to expect higher T-bill issuance in 2018 than the 25% to 33% guideline given by the TBAC. In the euro area, the ECB's data on EGB ownership shows that in 2Q17 compared to the previous quarter, eurozone investors' holdings of European general government bonds have decreased, by a total of €102bn, mostly due to Eurozone banks.

Inflation

In the US, we continue to like receiving in 1y1y CPI swaps while also suggesting best issues in front-end TIPS based on relative value. We see Powell's comments on the "mystery" of inflation as a sign that he may view inflation similarly to Yellen's model-based framework. In the euro area, we remain long 5y BTPei real yields, sticking with carry trades. Additionally, we remain cautiously bullish HICPxT inflation via 10s30s flatteners.

Money Markets

In the US, the TBAC's 2018 UST issuance recommendations led to steepening of the swap spread curve. We expect 2y spreads to continue tightening as a result, and recommend 10y spread wideners.

Derivatives

Everything the market was waiting for to take rates higher has come and passed. We think it's time to focus on carry trades for the rest of the year. We continue to like distributional trades with positive carry such as the 6m10y payer ladder and the 1y1y cap vs swaption wedge. Also as a tail hedge for a "no hike" scenario, we like EDZ7 99.625 calls at 0.5c. It can return up to 20x, much better risk / reward than receiving OIS at ~85%.

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Duration and Curves

Global summary

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Our Bond Market Indicators, BMI(10), reverted to neutral on duration across the G7, but our BMI(2) models initiated shorts in Treasuries, Bunds, gilts, and Canadian government bonds. Equity market performance continues to be a weight around the necks of government bonds globally, though surprises in business cycle data have turned more mixed. Most investors were hoping the past week would result in a breakout move higher in government bond yields. Instead, both Treasury and gilt yields fell in spectacular (and likely painful) fashion, while Bund and JGB yields fell less so. With leveraged fund and asset managers positioned for higher rates throughout the week, price action suggests those short positions have covered to a certain extent.

We remain neutral on duration, but positioned for rates to remain low and stable. **In the US**, we continue to suggest UST 2s30s flatteners, though we are on alert for chances to lighten up ahead of October CPI. **In the euro area**, we suggest staying long 5y German on the curve, and also staying long Italy/Spain vs. Germany/France. **In the UK**, we remain neutral on duration and curve. **In Japan**, we continue to suggest JGB 20s40s flatteners, and favor JPY swaps over JGBs for expressing long duration views.

Exhibit 1: Morgan Stanley Bond Market Indicators - BMI(10)

	Vol Adj. Carry	Momentum	Equity Markets	Business Cycle	FX/Rates	Average	Overall
UST	-3.7 (-1.8)	-7.9 (-5.1)	-1.2 (0.0)	-6.0 (-6.3)	-2.5 (0.8)	-4.3 (-2.5)	**0.0 (-2.5)**
DBR	4.8 (5.4)	1.9 (4.7)	-1.6 (-0.3)	-1.9 (-3.0)	-5.7 (-4.6)	-0.5 (0.4)	**0.0 (0.0)**
UKT	2.9 (4.2)	-6.2 (-1.9)	-2.2 (-0.4)	-0.3 (-2.2)	4.2 (3.4)	-0.3 (0.6)	**0.0 (0.0)**
JGB	0.4 (0.2)	0.9 (-6.4)	-4.0 (-3.6)	-4.0 (-4.0)	2.1 (-0.4)	-0.9 (-2.8)	**0.0 (-2.8)**
ACGB	8.2 (9.2)	-0.3 (-3.1)	-3.8 (-1.1)	-0.4 (-0.9)	-5.3 (-2.1)	-0.3 (0.4)	**0.0 (0.0)**
NZGB	6.6 (7.8)	-1.9 (2.7)	-1.5 (-0.6)	3.2 (-3.0)	3.7 (6.3)	2.0 (2.6)	**0.0 (0.0)**
CAN	-6.1 (-5.1)	-2.6 (-1.6)	-1.6 (-2.2)	-2.7 (3.3)	-1.9 (-5.2)	-3.0 (-2.2)	**0.0 (-2.2)**

Source: Morgan Stanley Research

Exhibit 2: Morgan Stanley Bond Market Indicators - BMI(2)

	Vol Adj. Carry	Momentum	Equity Markets	Business Cycle	FX/Rates	Average	Overall
UST	5.6 (7.2)	-9.5 (-9.6)	-1.2 (0.0)	-6.0 (-6.3)	3.0 (1.5)	-1.6 (-1.4)	**-1.6 (0.0)**
DBR	-6.0 (-5.2)	3.6 (4.7)	-1.6 (-0.3)	-1.9 (-3.0)	-3.7 (-2.4)	-1.9 (-1.2)	**-1.9 (0.0)**
UKT	2.4 (5.4)	-7.9 (-5.4)	-2.2 (-0.4)	-0.3 (-2.2)	0.5 (2.9)	-1.5 (0.1)	**0.0 (0.0)**
JGB	-5.7 (-4.9)	4.9 (5.6)	-4.0 (-3.6)	-4.0 (-4.0)	-4.6 (-4.0)	-2.7 (-2.2)	**-2.7 (0.0)**
ACGB	5.3 (7.9)	0.3 (-5.2)	-3.8 (-1.1)	-0.4 (-0.9)	-5.8 (-2.2)	-0.9 (-0.3)	**0.0 (0.0)**
NZGB	3.9 (4.5)	3.3 (2.5)	-1.5 (-0.6)	3.2 (-3.0)	3.5 (4.1)	2.5 (1.5)	**0.0 (0.0)**
CAN	-0.3 (0.2)	-3.6 (-3.4)	-1.6 (-2.2)	-2.7 (3.3)	-0.2 (-1.3)	-1.7 (-0.7)	**-1.7 (0.0)**

Source: Morgan Stanley Research
Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5 and cross-market restriction is not satisfied.

Exhibit 3: Summary of G4 strategic interest rate views through 4Q17

4Q17	US	Euro area	Japan	UK
Monetary Policy	**Policy rate:** Dec-17 hike, four hikes in 2018. Balance sheet: Unwind announced in Sep-17 and started in Oct-17.	**QE:** ECB tapering announced in Oct-17, starting from Jan-18 and ending in mid-2018. Policy rate: The first 15bp depo rate hike to -0.25% in Sep-18.	**Long-term target:** Jan-Mar 2018 adjustment to the long-term interest rate target. Policy rate: First hike in the short-term policy rate in Jan-Mar 2019.	**Policy rate:** Risks to continued monetary policy stance tilted to hawkish in the near term because of above-target inflation and to dovish in the longer term on Brexit uncertainty.
Duration	**10y UST at 2.45%** Decreasing growth and economic data expectations together with a global demand for yield keeping a lid on the 10y despite the projected Fed hiking cycle.	**10y Bund at 0.60%** Yields edging higher on ECB extraordinary policy measure unwind and continued tight German funding markets because of QE-induced scarcity.	**10y JGB at 0.08%** Continued monetary policy to keep the 10y rangebound.	**10y Gilt at 1.00%** Political risks keeping domestic demand and growth subdued in the near term, balancing a MPC on hold and possibilities of fiscal expansion.
Curve	**2s10s at 0.95%** Hiking cycle bumping the front end to a flat FF-2y slope, more so than the increase in 10y yields, resulting in a bear flattening curve move.	**2s10s at 1.20%** Gradual policy normalization will maintain the curve slope, but measures to ease funding market scarcity tilt risks to steepening.	**2s10s at 0.26%** Steepening bias as our Economists are forecasting higher inflation and a BoJ preparing for policy tightening in 2018.	**2s10s at 0.90%** Scenarios of weaker or stronger economic performance affecting the long end would be accompanied by relevant MPC policy, keeping the curve slope around current levels.
Inflation	**Lower breakevens** Weaker realized inflation from structural and idiosyncratic factors and tighter Fed policy to keep inflation expectations low.	**Inflation curve bull flattening** Medium-term gradual inflationary recovery leading to a bull flattening of the inflation term structure.	**Risk-reward in breakevens** Risk-reward in JGBi in an environment where markets are not pricing in our Economists' forecasted wage-driven inflation boost.	**Inflation curve bear steepening** An accommodative MPC allowing for continued strong, but decreasing, realized inflation, resulting in a bear steepening of the inflation term structure.
Spreads	**Long belly swap spreads** Increased floater issuance reduces the pressure on belly spreads. Deregulation propositions reducing the cost of balance sheet allows spreads to converge to fundamental fair value.	**BTP-Bund spread at 190bp** Mild widening in 2H17 triggered by an autumn start to ECB renormalization and Italy election uncertainty.	**USD/JPY xccy basis remaining tight,** but the risk of widening in 3Q global USD funding environment remain favorable, thereby less widening pressure in near term. However, short-end basis could widen in 3Q because of resumed T-bill issuance, Fed balance sheet unwind and Japanese investor foreign bond demand**.**	-
Volatility	**Neutral Gamma, bullish Vega** Subdued realized vol is incentivizing vol selling strategies, which is keeping gamma offered, whereas vega should be supported by less Formosa callable issuance**.**	**Tactical short in Gamma, bullish Vega** Realized volatility likely to stay low for the rest of the summer, whereas vega should be supported by continued strength in economic data and ECB tapering.	**JGB ASW flattening, lack of vol** JGB ASW flattening to remain until the BoJ shows a clear stance on "exit strategy"; vol to remain subdued in the current monetary policy environment.	**Buy 3m6m 10y calendar spread** We recommend taking advantage of the current flat term structure of volatility to express a bullish view on 10y tails, which looks cheap on different metrics.

Source: Morgan Stanley Research

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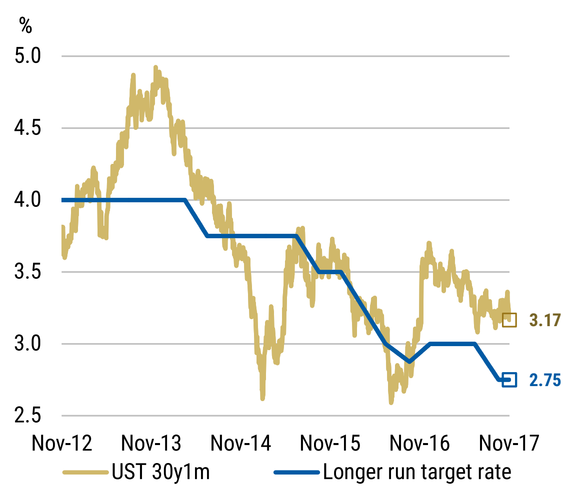
Keep the strategic flattener on, but lighten up ahead of CPI

We continue to suggest investors maintain strategic UST 2s30s flatteners. A negative term premium persists in the front end of the curve with the market-implied pace of rate hikes (at 2 x 25bp hikes over the next 12 months) still below the expectation of most investors (at 3 x 25bp hikes). In addition, the steepness of the yield curve continues to imply a longer-run policy rate above that which the median FOMC participant projects.

Exhibit 4 shows a history of the FOMC's median longer-run neutral policy rate and the market-implied version of the same concept plus a term premium component. The market has been about 75bp over the Fed before, and about 75bp below the Fed before. Today, we calculate the market-implied longer-run policy rate at 42bp above the Fed's 2.75% median longer-run neutral rate. If we assume the market's longer-run policy rate expectation matches the Fed's (not unreasonable), then the difference between the market and the Fed should reflect a term premium – which is currently positive and ripe for harvesting, in our view.

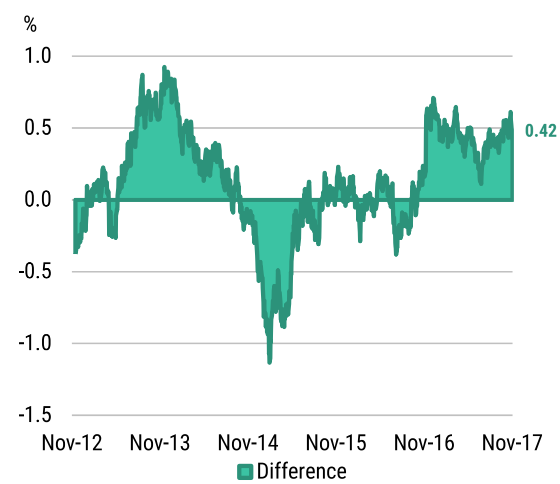
What about the risk that tax reform steepens the yield curve? The release of the US House tax reform bill and the Joint Committee on Taxation (JCT) scoring coming in under the $1.5 trillion ceiling (static) imposed by the 2018 budget resolution moved us one step closer to passage. We think passage of a similarly scored bill being signed by the president is mostly in the price of the Treasury markets, both in terms of the monetary policy implications of tax reform and deficit expansion, and also the way in which those deficits will be funded (see Tax Reform - Better to Travel than Arrive).

Exhibit 4: UST 30y1m implied forward yield vs. the FOMC median longer-run projected policy rate



Source: Morgan Stanley Research, Federal Reserve

Exhibit 5: UST 30y1m implied forward yield less the FOMC median longer-run projected policy rate



Source: Morgan Stanley Research, Federal Reserve

Even if deficits are larger than we expect, we see the way in which Treasury funds them as being less of a curve steepener than before, given the Treasury refunding announcement on November 1. The TBAC minutes suggested that, "Given the current fiscal outlook, the Committee agreed that Treasury should focus on increasing issuance in bills and the 2-, 3-, and 5-year sectors, while maintaining issuance at the long end such that the WAM does not materially change from current levels." This leaves us comfortable owning duration, especially when the price of duration already gives the Fed credit for achieving its 2 percent inflation goal.

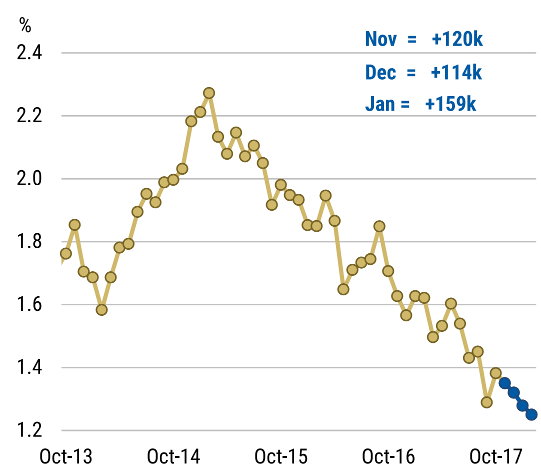
At the same time, nothing moves in a straight line forever, including yield curves. A key risk to the flattener would be the Fed passing on a December rate hike. Markets are pricing in over an 80% chance of a December hike – a near certainty. Indeed, the Fed sent no conflicting signals at its November meeting. However, **we think the upcoming CPI report has game-changing potential.**

The October CPI report will be the last one the Fed will have in hand before Chair Yellen makes her consensus-building round of phone calls to other FOMC participants ahead of the December meeting (the BLS released the November CPI report on the 2nd day of the December FOMC meeting, though the Fed may have the results on the evening of the 1st day). If the October CPI report misses expectations to the downside, and more FOMC participants express concern, market-implied probabilities for a December hike could move lower to 50%. In this type of move, we think the 2s30s curve would steepen. As a result, we be looking for a location to pare back exposure to the 2s30s flattener over the coming week or so.

The payroll party-pooper...

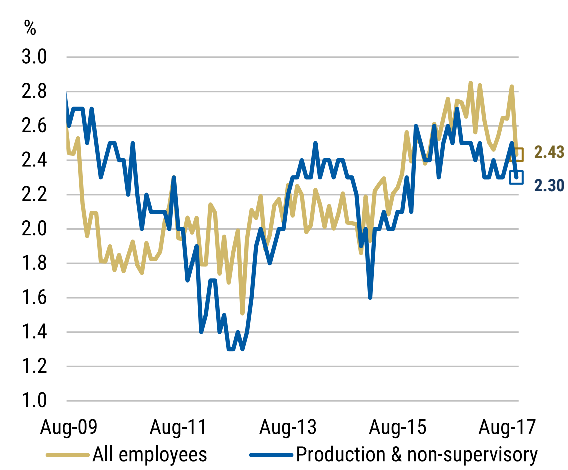
As if bond market shorts needed any more frustration this week, the nonfarm payroll report for October provided no joy. This report and the last one were heavily impacted by the hurricanes, so the upcoming reports should provide a cleaner read of what is happening in the labor market. Going forward, what can we expect from payroll growth? Our Y/Y trend analysis displayed in Exhibit 6 suggests monthly gains in total nonfarm payrolls should average 131k over the next three months.

Exhibit 6: Total nonfarm payroll growth Y/Y and 12m trend projection



Source: Morgan Stanley Research, BLS

Exhibit 7: Average hourly earnings: All employees, production & non-supervisory employees



Source: Morgan Stanley Research, BLS

While a growth rate of 131k/month would be sufficient to keep downward pressure on the unemployment rate, in all likelihood, it would represent a further downward adjustment from the 139k growth in total nonfarm payrolls over the past two months. Continued deceleration in payroll growth, while expected generally, contrasts with the higher rate of economic growth we have been tracking. The advance estimate for 3Q17 real GDP came in at 3.0%, and our US economists are tracking 4Q17 real GDP at 3.4%.

The expected deceleration in payroll growth comes alongside continued stability in the rate of wage inflation. There have been few signs of acceleration in the core rate of wage growth over the past several years. Wage growth for production and non-supervisory workers registered 2.3% Y/Y growth in October. That represents the same level of wage growth seen throughout 2013 and most of 2014 (see Exhibit 7).

… and Powell

The president of the United Stated nominated Governor Powell to replace Yellen as Fed Chair next year. Our US economists provided their view on Powell in Governor Powell Named as Next Fed Chair. In their view, Chair Yellen and Governor Powell are like-minded on monetary policy, and he will likely maintain consistency and continuity, but support a lighter regulatory stance. Our economists continue to expect 3 rate hikes in 2018.

In his first remarks as nominee for Fed Chairman, Powell dropped a hint that he is going to continue to operate in the tradition of Bernanke and Yellen (***our emphasis***):

> *I've had the great privilege of serving under Chairman Bernanke and Chair Yellen, who guided the economy with insight and courage through difficult times while moving monetary policy toward* ***greater transparency and predictability****.*

This suggests to us that the dot-plot and a gradual pace of policy normalization is likely to remain a key feature of FOMC communications and actions. Powell went on to suggest that he was "committed to making decisions with objectivity based on the best available evidence in the long-standing tradition of monetary policy independence." That seemed a clear indication that he and the Committee would remain focused on their dual mandate and keep politics out of their considerations.

In terms of his take on the economy and the banking system, Powell suggested that,

> *...by many measures, we are close to full employment, and inflation has gradually moved up toward our target. Our financial system is also without doubt far stronger and more resilient than it was before the crisis. Our banks have much higher capital and liquidity, they're more aware of the risks that they run, and they're better at managing those risks. While post-crisis improvements in regulation and supervision have helped to achieve these gains, I will continue to work with my colleagues to ensure that the Federal Reserve remains vigilant and prepared to respond to changes in markets and evolving risks.*

When will Powell next speak?

Putting aside the off chance that Powell makes a public media appearance before being sworn in, the first opportunity to hear from the nominee will be at the confirmation hearing, probably between the Thanksgiving and year-end holidays. After that, we expect the first time Powell will speak on monetary policy in an official capacity will be at the semiannual Monetary Policy Report to the Congress, expected in February 2018. Our expectation is based on what Yellen and Bernanke did after their respective nominations.

Yellen was nominated on October 9, 2013, but aside from her confirmation hearing, didn't give her first speech until the semiannual Humphrey-Hawkins testimony on February 11, 2014 (see Semiannual Monetary Policy Report). She addressed the FOMC's January 28-29 monetary policy decision in which she naturally took part as Vice Chair. We were not able to find any pre-swearing-in media appearances. Her next appearance was on March 5, 2014, and she spoke twice more in March, with none of the speeches touching on monetary policy. However, her third speech in March 2014 addressed the labor market and famously described the experiences of Dorine, Jermaine, and Vicki. It was seen as a dovish speech. Yellen's next speech dedicated to monetary policy was on April 16, 2014 (see Monetary Policy and the Economic Recovery).

Bernanke was nominated on October 24, 2005, but again, outside of his confirmation hearing, didn't give his first speech until February 6, 2006, in his remarks at the ceremonial swearing-in. He did not address monetary policy at that point. For Bernanke, who was head of the Council of Economic Advisors, it made more sense for him to refrain from speaking until after being sworn in. We were not able to find any pre-swearing-in media appearances. Bernanke spoke next at the semiannual Humphrey-Hawkins testimony on February 15, 2006 (see Semiannual Monetary Policy Report). He addressed the FOMC's January 31, 2006, monetary policy decision, even though he was not at the meeting. Bernanke's next speech dedicated to monetary policy was on March 20, 2006 (see Reflections on the Yield Curve and Monetary Policy).

Tax reform a done deal? Hardly.

As expected, the House released the Chairman's mark tax reform bill this past week. The bill is named the "Tax Cuts and Jobs Act". Our public policy strategists provided an update in its wake (see Tax Reform Still at the Drawing Board). They believe outcomes skew toward modest stimulus with execution risk. Their next focus is on the markup and whether pay-for battles risk an 'all or none' stimulus scenario. One of the key areas of focus for rates markets was how the House bill would score on the deficit impact. The JCT released its static score on Thursday evening, November 2.

The JCT estimates the static impact on the deficit at $1,487bn over the next 10 years and $114.6bn in fiscal 2018 (running from October 2017 through September 2018). The implied calendar-year deficit hit might be something closer to $170bn, if you take a quarter of the impact from fiscal year 2019 ($221.3bn / 4 = $55.25bn), assume it hits in 4Q18, and add it to the fiscal year 2018 projection of $114.6bn. The score assumes the date of enactment is December 1, 2017, and most of the major provisions are effective January 1, 2018. The following fiscal years have larger projected deficits. $221.3bn in 2019, $210.9bn in 2020, $193.5bn in 2021, and $180.4bn in 2022.

While the front-loading of the deficit impact was slightly higher than we assumed, we don't think it changes the calculus much for Treasury issuance. Of course, the bill now enters its mark-up phase, so is bound to change in ways that will impact the deficit scoring. But it seems reasonable to assume that changes will be made such that the maximum increase in the deficit over the 10-year budget window will still be $1.5 trillion. Apart from the mark-up process, we will pay close attention to how the JCT scores the House bill on a dynamic basis - the timing of which is unclear. The deficit impact after dynamic scoring may have implications for eventual passage of a combined bill with the Senate.

The Senate, of course, has yet to release its bill – which we assume will also comply with the $1.5 trillion deficit ceiling laid out in the 2018 budget resolution. If the Senate bill, after dynamic scoring, adds to the deficit, it's not clear it will have the votes it needs to pass. For example, Senator Bob Corker (R-Tenn.) appeared on Meet the Press with Chuck Todd on October 1. When asked about his beliefs on the deficit, he said, "I am a deficit hawk." When asked about what a hole in the deficit looks like to him, Corker said,

> *I'm willing to accept the realities of where we are, which is we have a policy base, in other words taxes, kind of like the doc-fix, we kept making up the fact this was going to change. So I'm willing to accept current policy, number one, I think that's rational. And I'm willing to accept a reasonable score on dynamic growth. A reasonable score on dynamic growth. Joint Tax does those, there are some other groups that do it. But if it looks like to me, Chuck, that we're adding one penny to the deficit, I am not going to be for it. Okay, I'm sorry. It is the greatest threat to our nation. The greatest threat to our nation… … It's like, Chuck, we've entered a party atmosphere here. Everybody was a fiscal hawk, kind of, not really, but kind of up until the election. Now it's like there's a party going on up here. Heck with revenues, heck with constraining spending. So, yes, I will remain a deficit hawk until I leave here. And I'm looking so forward to this tax reform debate because the one thing that hasn't been discussed is the 4 trillion dollars in base broadeners that have to occur for this to be successful. And every lobbyist in the world is going to be up here fighting those.*

As a result, we think the risk yet to be priced into the Treasury market is a tax reform bill that delivers less than a $1.5 trillion static increase in the deficit over the 10-year budget window. This is another reason we do not feel comfortable going short duration, and a reason why we remain in yield curve flatteners.

Trade idea: Maintain UST 2s30s flatteners at 119bp

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Nov hike delivered, but data-dependent thereafter

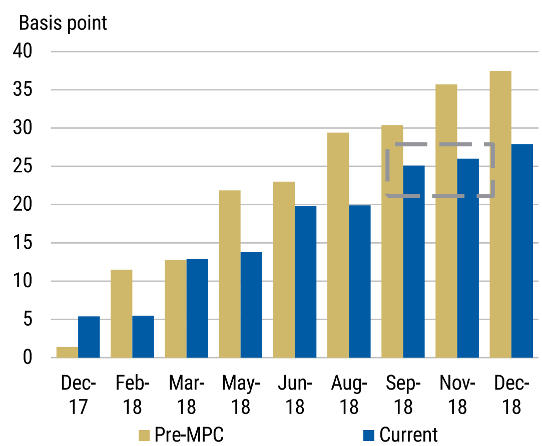
The MPC delivered the first rate hike in a decade at the Nov 17 MPC meeting this week, as widely expected, with the strong support of a 7-2 vote. However, even though the vote split was skewed towards the hawkish side, the shift towards a more gradual, and Brexit/data-dependent rate path thereafter failed to reassure the market on the timing of the next hike (see MPC: One Hike per Year).

This has led to an aggressive rally in the UK rates curve, across the entire term structure, in reaction to the MPC. Prior to the meeting, the market had been pricing in close to 90% chance of a second rate hike in May 18, after the meeting it has now re-priced to only 55% chance (see Exhibit 8), close to our economists' forecast of a 60% probability of a May 18 hike.

The re-pricing of the rate expectation has been the primary driver of the rally on the gilt curve. Looking at Exhibit 9, the 30-40bp sell-off we had in 5-10y gilts since early September, after a series of strong data in the UK and followed by a hawkish September MPC meeting, has been primarily led by the rate expectation component, contributing ~25bp to the ~35bp sell-off in 5-10y gilts, where term premium has been fairly stable.

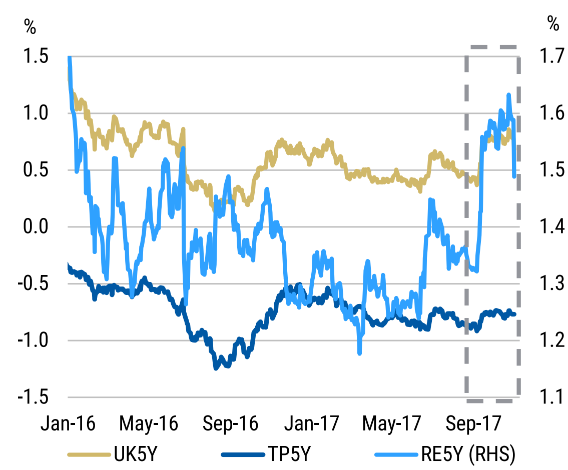
After the post-MPC rally this week, the rate expectation component has reversed almost half of the sell-off, which makes sense to us given that the MPC suggests the hiking cycle is still on-going, but at a much more gradual and nimble pace. Therefore some probability of a rate hike has to be priced in, but more or less halved from what it was prior to the Nov MPC meeting.

Exhibit 8: Market implied rate hike for UK MPC



Source: Bloomberg, Morgan Stanley Research

Exhibit 9: 5y UK yield decomposed into rate expectation and term premium component



Source: BoE, Morgan Stanley Research

Selective hearing

The hawkish sentiment in the market prior to the Nov MPC meeting this week was partly led by the speech from Governor Carney on Sep 18th, when markets traded on what they wanted to hear in the lead up to this meeting, and ignored the clearly dovish overarching message. The hawkish portion of Carney's guidance was heavily caveated with data dependence, and the dovish portion of his message clearly spelled out a gradual and limited policy path with more tolerance for inflation overshoot than would be warranted outside of extraordinary circumstances - namely, Brexit.

Food for the hawks | Still data dependent

"The MPC's reaction function is clear. The continued erosion of slack lessens the trade-off that the MPC is required to balance and, all else equal, reduces the MPC's tolerance of above-target inflation." p.23

"... if the economy continues to follow a path consistent with the prospect of a continued erosion of slack and a gradual rise in underlying inflationary pressure then, with the further lessening in the trade-off that this would imply, some withdrawal of monetary stimulus is likely to be appropriate over the coming months in order to return inflation sustainably to target...The case for a modest monetary tightening is reinforced by the possibility that global r may be rising, meaning that monetary policy has to move in order to stand still."* p.23

Feast for the doves | Gradual and limited

"The MPC's remit specifies that, in exceptional circumstances such as Brexit, the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity." p.21

"That said, I would caution that the persistence of major secular factors pushing down on the long-run global equilibrium real rates still means that policy rates can be expected only to rise a limited extent at what can be expected to be a gradual pace, settling at levels significantly below those seen pre-crisis" p.17 Governor Carney, September 18, 2017

How to position?

The front-end curve is pricing in line with our economists' base case and the retracement on the gilt yield has been primarily led by the rate expectation component where it looks fair pricing to us. The MPC gave no additional clarity on the pace of the hiking cycle given the full dependence on data and the Brexit outlook, the risk/reward to directionality of rates and even curve implication is more symmetric. Our BMI also remains neutral on the signal, and given the strong short momentum continued to be offset by the vol-adjusted carry and the FX signals, we remain neutral on UK rates.

Japan

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BoJ MPM outcome sounds dovish vs market expectation

The October 30–31 BoJ monetary policy meeting ended up being of little interest with the exception of an upward revision of the central bank's FY2017 GDP growth forecast and downward revisions of its FY2017 and FY2018 inflation projections.

Some foreign investors had expected BoJ Governor Haruhiko Kuroda to offer hints regarding "exit strategy" in his post-meeting press conference, but asked whether the BoJ might look to adjust the yield curve before inflation reaches the +2% target level, Kuroda responded as follows.

> *A number of indicators show that the economy has been steadily improving. Unfortunately, however, although price trends have improved quite significantly by comparison with a year ago, our "price stability goal" of +2% inflation remains well out of reach, with core CPI inflation (all items less fresh goods) running at around +0.7% or just +0.2% if energy-related items are also excluded. As such, **we see no need to alter our "yield curve control" framework at this juncture.** Any decision as to whether our marginal policy rate of –0.1% and/or our 10y yield target of around zero will be adjusted before or after achieving +2% inflation will necessarily depend on prevailing economic circumstances, price trends, and financial conditions. Our basic stance on monetary policy is thus unchanged in the sense that **our ultimate objective is to achieve +2% inflation on a sustainable basis.***

It would therefore appear that the BoJ has no intention of making major changes to monetary policy with inflation remaining even further away from +2% than in the US and Europe (see Exhibit 10). The natural takeaway is that policy adjustments will be considered premature in the absence of significant improvements in inflation indicators.

Our economics team believes that the BoJ is unlikely to start giving serious thought to "exit strategy" until and unless so-called "underlying" inflation—all items less fresh food and energy—approaches (at least) +1%.

Domestic and overseas players reacting differently

As discussed in our Global Interest Rate Strategist: Americas' Next Top Fed Chair is... report, recent movements in the JSCC-LCH basis and JGB asset swap spreads suggest that domestic and foreign players have differed in their reactions to BoJ-related news and speculation (see Exhibit 11).

The consensus view among domestic investors in the wake of this week's BoJ meeting is seemingly that the "yield curve control" (YCC) framework is set to remain in place, with subsequent declines in gamma-sector volatility suggesting that some players have started to sell volatility with a view to earning premium income (see Exhibit 12).

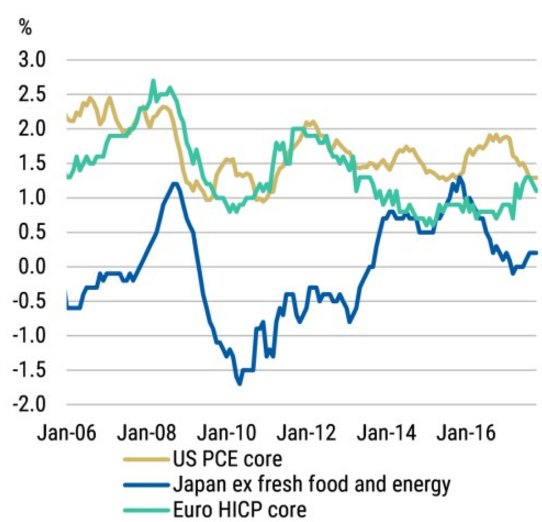
We have also seen buying flows in the super-long JGB sector even in the first days of November, which we interpret as evidence of life insurers and other real money investors accepting that their previous target yield levels may have been a little on the high side.

Meanwhile, however, overseas investor expectations an early commencement of (more obvious) BoJ tapering are seemingly still intact. The JSCC-LCH basis did tighten temporarily in the wake of the BoJ meeting as paying positions in super-long JPY swaps were unwound, but remains quite wide by longer-term standards (see Exhibit 11). Foreigners are perhaps willing to stick with paying positions in the belief that downside should be limited by the BoJ's determination to prevent the yield curve from flattening excessively.

However, pressure to unwind such positions may gradually build if volatility remains low as a consequence of the BoJ persisting with YCC. Volatility currently looks expensive around the 10y point of the swaps market gamma sector, suggesting that many foreign players have been expecting an adjustment of the BoJ's target level for the 10y JGB yield (see Exhibit 13).

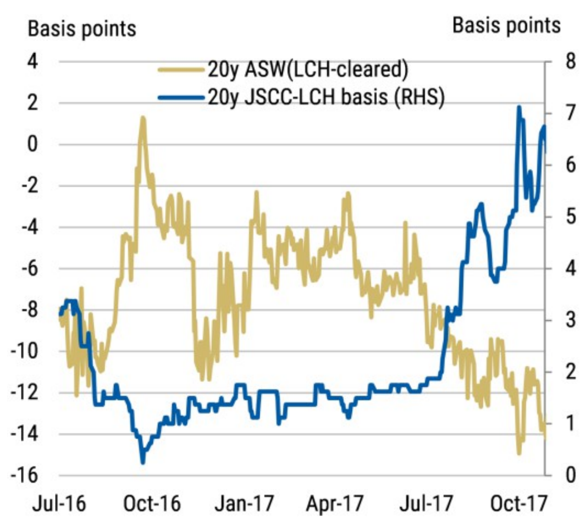
The near-term domestic calendar looks quite uneventful now that the BoJ meeting has passed, suggesting that the YCC framework should continue to keep JGB yields quite narrowly range-bound. The next major focus will perhaps be the December 1 CPI release, and if volatility remains low due to a lack of evidence that underlying inflation has quickened, we would expect to see a gradual increase in trades focusing on carry and rolldown. **As such, we believe that risk/reward currently looks better for positions premised on declines in JPY rates.**

Exhibit 10: Global core CPI history



Source: Bloomberg, Morgan Stanley Research

Exhibit 11: The long-end ASW and JSCC-LCH basis

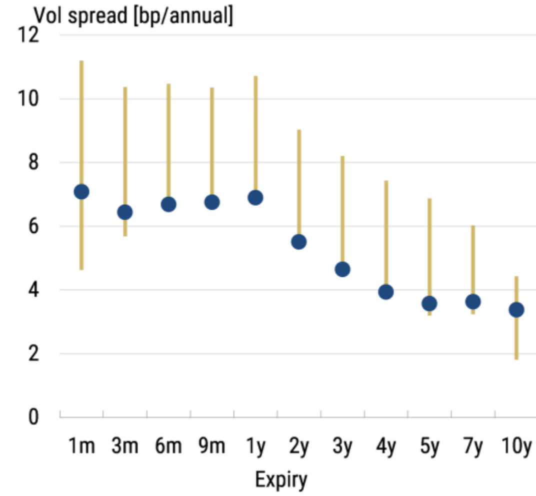


Source: Morgan Stanley Research

Exhibit 12: JGB historical volatility and swaption implied volatility

Source: Morgan Stanley Research

Exhibit 13: 5s10s20s vol fly across the expiry



Source: Source: Morgan Stanley Research

30y auction preview

A 30y JGB auction is slated for next Thursday. We expect the auction itself to go reasonably smoothly, with the recent strength of the super-long sector suggesting that dealers may have some short positions to cover.

Life insurers have indicated that they intend to reduce or at best maintain their JGB holdings during 2H FY2017 (through March 2018), but the 30y–40y portion of the curve has been outperforming of late. As discussed in our Global Interest Rate Strategist: Americas' Net Top Fed Chair is... report, lifers were only minimal buyers of JGBs in 1H FY2017.

We therefore expect to see an increase in ALM-driven super-long JGB purchases with an eye to the (end-March) fiscal-year close (see Exhibit 14), and also note that the behavior of lifers tends to exhibit a certain amount of "persistence". As such, we see potential for the super-long sector to keep outperforming even beyond Thursday's auction as 30y JGBs remain in relatively strong demand.

How best to position?

US tax system reforms look set to be the main focus of attention now that central bank meetings are behind us and President Trump has nominated a successor to Fed Chair Janet Yellen, We thus see a high likelihood of volatility holding steady for at least the time being.

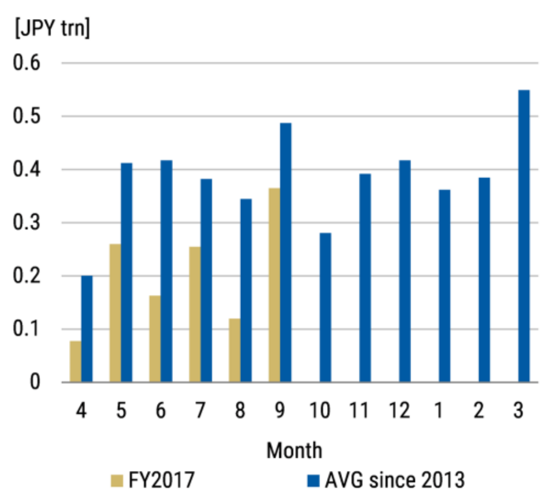
Overseas factors basically look supportive for bonds. The ECB has confirmed that it intends to persist with its quantitative easing through at least September 2018, and while non-commercial short positions had been built up amid hopes for US tax reforms and concerns that (comparatively hawkish) Stanford University economist John Taylor might be chosen to succeed Yellen, these are likely to be at least partially unwound now that current Fed Governor Jerome Powell has been nominated to head the Fed and the Treasury's quarterly refunding announcement has confirmed that coupon-bearing UST (T-bond and T-note) issuance will not be increased over the next three months.

Our US political economics team also sees a growing risk of the Trump administration and Congress failing to agree on any sort of tax reform package before the end of this year (see Tax Reform - Better to Travel than Arrive), and anticipates a renewed focus on the debt ceiling problem and the possibility of a federal government shutdown once December gets under way.

Based on our assessment of foreign investor positioning, overseas factors, and the BoJ's monetary policy stance, we see a growing risk of JPY rates declining during November. We therefore continue to recommend a 20s40s flattener. The 20s40s spread has indeed tightened somewhat of late, but the super-long end of the curve still looks cheap, and we expect 40y JGBs to be favored by lifers for ALM purchases by virtue of their long durations and high yields.

We favor JPY swaps over JGBs for expressing duration-long views, believing they offer greater upside (in the event of a decline in interest rates) due to both positioning imbalances and recent (quite significant) widening of ASW spreads (see Exhibit 15). The main risk to this trade is perhaps that of a temporary correction in overseas interest rates.

Exhibit 14: Lifers' super long JGB purchase



Source: JSDA, Morgan Stanley Research

Exhibit 15: Receive LCH-cleared 20y swap

Source:Morgan Stanley Research

Trade idea: Receive JPY 20y swap outright LCH cleared at 0.7225%

Sovereigns

United States
We examine the main points made in the TBAC and Treasury November refunding statement which came mostly in line with our expectations. Coupon auction sizes remained unchanged and the TBAC recommended increased issuance next year to be focused on 2s, 3s and 5s.

While the TBAC recommended that the share of T-bills in issuance over the coming years be in the range of 25% to 33% of total issuance, we think T-bill issuance in 2018 and 2019, might actually be higher than that. Our forecast for higher T-bill issuance in 2018 would partially compensate of the lack of positive net T-bill issuance in 2017 and meets the objectives of balancing the T-bill demand supply picture, without shortening the WAM over the next two years.

We also examine the JCT scoring of the House tax bill and judge that our 2018 issuance forecasts are in line with the JCT's expected deficit.

Euro area
ECB's updated data on EGB ownership shows that in Q2 17 compared to the previous quarter eurozone investors' holdings of European general government bonds have decreased, by a total of €102bn, mostly due to Eurozone banks. Analogously, non-eurozone investors have been net buyers of eurozone government debt, but only marginally.

United States - TBAC, JCT and the issuance outlook

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Highlights from the Refunding Statement
The Treasury refunding statement on Wednesday came in line with our expectations for no increase in coupon issuance over the next three months. The market was surprised by that lack of increase in coupon issuance as well as the TBAC's suggestion that WAM does not need to be extended further which led to the 2s30s treasury yield curve flattening and 30y swap spreads gapping wider.

We summarize the statements and recommendations of the Treasury and the TBAC below, then examine how that fits in our forecast for 2018 supply levels and composition. In short, we see the announcements as in line with our current forecasts and do not revise them.

- **Coupon issuance remains fixed** for until at least February

- It was unanimously agreed by TBAC that **increased issuance should favor T-bills and the belly of the curve (defined as 2s, 3s, and 5s)** along with longer-term issuance so that the outcome would result in no material change in the WAM.

- Over the coming years the **share of T-bills in funding the additional deficit should be between 25% and 33%.**

The first and second points came in line with our expectations which we discuss in more detail in the US Public Policy piece (October 30, 2017). To reiterate, we expect the treasury to announce a monthly increase in auction sizes of $4bn for 2s, 3s, and 5s and $2bn for 7s, 10s, and 30s starting in February 2018.

WAM not increasing

The reasoning the TBAC gave about recommending an emphasis on 2s, 3s, and 5s is that while an increase in WAM was desirable to reduce the volatility of funding costs when WAM was much shorter, increasing it further could actually be undesirable as it increases funding costs with only a marginal reduction in the volatility of funding costs.

We believe this view on the WAM was behind the aggressive bull flattening and 30y swap spread widening. However, the view should not have come as a surprise as the tone of the TBAC's discussions regarding WAM from the prior meeting reflected a similar sentiment. For example, in the August 2017 TBAC report to the Treasury, it was stated that:

> The risk is that by using WAM as a single metric exclusively, the market mistakenly infers that a mechanical increase in longer-term coupons is optimal. It’s not.

Only 25% to 33% Bills?

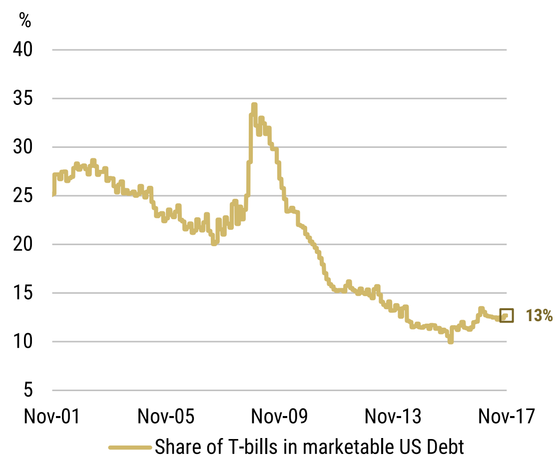
One point on which the TBAC recommendations might seem to differ from our 2018 forecast for the issuance mix is the role of T-bills.

Our projection is for $717bn net increase in issuance next year, of which $337bn is in net T-bill supply. That is, we estimate T-bills would meet 47% of the additional funding gap next year. Even after accounting for the fact that part of the increased funding need next year is due to the need to raise the cash balance by $100bn, T-bills would still be used to fill 38% of the increase in budget deficit and SOMA portfolio redemptions next year. That is still above the 25% to 33% range that the TBAC recommended. So how do we reconcile that?

First we take a step back to see why the TBAC does not think the share of T-bills in funding the additional deficit should exceed one third.

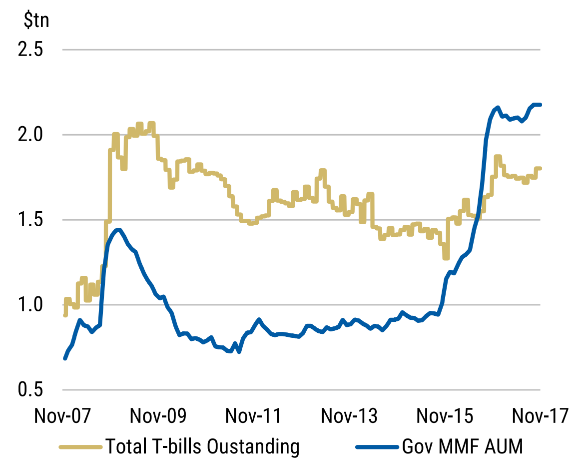
The TBAC continued to acknowledge the shortage of T-bill supply in money markets that resulted in part from the increased AUM of money market funds due to the 2016 MMF reform. The AUM has surpassed the total amount of T-bills outstanding for the first time in at least a decade (see Exhibit 17). It is an issue we have repeatedly highlighted before (see Waiting for Reflation with Flatteners and The Hawks Went 2 for 4). T-bills are still only 13% of total marketable debt outstanding, compared to an average of 22% for the years before the crisis (see Exhibit 16).

Exhibit 16: T-bills outstanding as a share of total marketable US debt



Source: US Treasury, Morgan Stanley Research

Exhibit 17: Government MMF AUM vs total T-bills outstanding



Source: Crane Data, US Treasury, Morgan Stanley Research

However, the TBAC also noted a significant increase in T-bill issuance risks shortening the WAM which could potentially introduce undesirable volatility in funding costs and/or require an offsetting increase in issuance of long-term coupon Treasuries to offset the impact on the WAM.

As Exhibit 19 from the TBAC's presentation shows, financing the deficit only by issuing more T-bills would lead to an immediate reduction in the WAM. However, using the recommended 25% to 33% would lead to a moderate increase in WAM that stabilizes over time.

Our 2018 forecast most closely corresponds to the scenario where issuance is 50% in T-bills. While that scenario would eventually lead to a drop in the WAM, **we note that the drop would not occur until after 2021**. Thus, we think our forecasted issuance mix for the near term, where T-bills constitute 40% to 50% of additional issuance is actually consistent with the TBAC's objectives of:

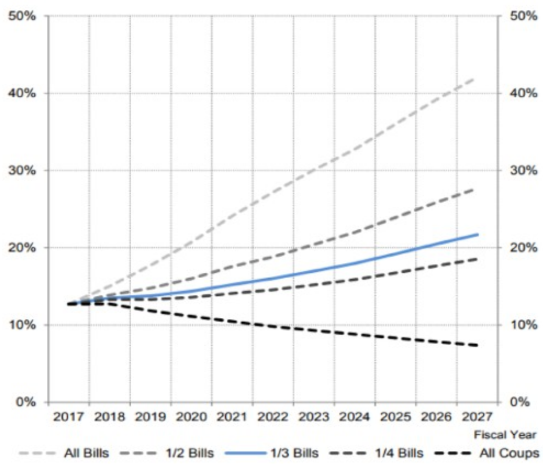
1. Meeting the increased demand for T-bills
2. Maintaining the WAM at or above current levels

To be clear, we do not expect T-bills to remain at above 40% of issuance for more than two years. In fact, we expect them to move into the 25% to 33% range by 2020.

In the meantime, the Treasury would be able to address the T-bill shortage issue, which is only likely to worsen as:

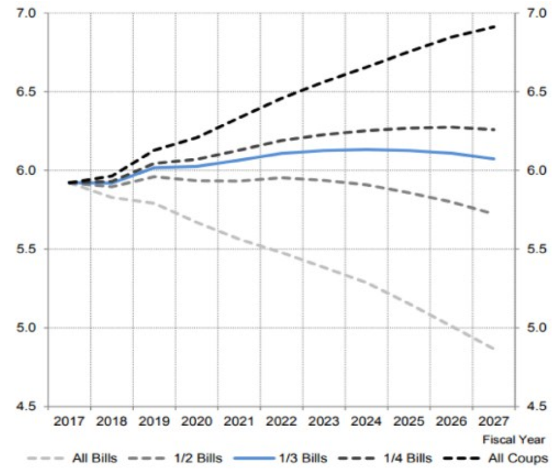
- The continuous flow of funds into MMFs continues (a topic we highlighted in earlier publication)
- And as the Federal reserve might start considering eliminating or scaling back the RRP facility which has been absorbing around $300bn in funds from domestic and foreign investors

Exhibit 18: Bills as a percentage of marketable debt under issuance scenarios



Source: TBAC
Note: The assumed total size of debt issuance is based on the mean estimate for borrowing needs from the PD survey

Exhibit 19: Weighted Average Maturity in years for the debt under issuance scenarios



Source: TBAC
Note: The assumed total size of debt issuance is based on the mean estimate for borrowing needs from the PD survey

Tax Reform and Supply Needs

Based on the above analysis, we maintain our forecast for the composition of the issuance mix in 2018. But what about the magnitude?

We judge that the House tax bill released on Thursday was in line with our base case scenario. Morgan Stanley's Public Policy team discusses the details of the bill and how they compare to our base case in Tax Reform Still at the Drawing Board. For the purpose of 2018 issuance forecasts, we refer to the JCT's (Joint Committee on Taxation) estimate of the 2018 deficit associated with the bill.

According to the JCT's scoring, the bill would add $114bn in deficit to fiscal year 2018 and $221bn to FY 2019. This translates to $160bn - $180bn of deficit for CY 2018 depending on assumptions on when the actual bill would be passed and the seasonality of the deficit through the fiscal year. This is slightly higher than the $152bn we had penciled for the impact of tax reform under our base case.

However, we do not see that difference as significant enough to warrant a revision, since the estimates for the bill's impact could still change under the final bill. Additionally, a miss in the magnitude of $10bn or $20bn can simply be met through increasing T-bill issuance.

In any case, we continue to watch developments on the fiscal policy front, as we approach the end of the year for any implications to our forecasts.

Euro area - Developments in EGB ownership

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Tracking ownership developments

As part of our regular monitoring of ownership development in Euro sovereign bonds, we review the latest update to the ECB's security holdings statistics (SHS) database, a quarterly standardized dataset of Eurozone holdings of general government debt broken down by holder sector, instrument type and issuer sector, for data as of Jun-17.

We perform an adjusted breakdown analysis using the total general government debt and combining the SHS database with data from the ECB's APP programme, BIS, Eurostat and Japan MoF. Exhibit 20 shows the latest reporting of investor breakdown of the major Eurozone countries as of June 2017, revealing that Eurozone investors hold roughly 53% of the total European general government debt, plus another 17% held by the ECB, leaving around 30% of the total to non-Eurozone investors.

Exhibit 20: European government bond ownership breakdown as of Jun-17

EUR bn	Total General Govt Debt *	PSPP **	SMP	Total Eurozone holding **	of which: Insurance Pension	of which: Banks	of which: Other Financials	of which: Others	Non-Eurozone Holding
Italy	1,925	243	50	1,298	392	444	261	201	335
Spain	971	166	21	607	208	250	118	32	176
Portugal	160	27	10	112	22	50	14	26	11
Ireland	131	19	8	63	24	24	14	2	42
Germany	1,613	334	-	586	124	224	151	86	694
France	1,904	266	-	837	454	197	157	29	800
Belgium	397	45	-	247	126	63	36	22	106
Austria	257	37	-	151	54	50	24	23	69
Finland	107	23	-	41	14	15	9	3	43
Netherlands	335	74	-	161	82	45	31	3	100
Total	7,799	1,234	89	4,102	1,499	1,363	815	425	2,375

Note: * Total general government debt includes both central and regional government debt. ** Convert from market value to nominal value using weighted average price of each sovereign as of the end of each period. Source: ECB, Eurostat, Morgan Stanley Research

Exhibit 21 depicts a relatively modest development in ownership and shows that compared to the previous quarter, Mar-17, eurozone investors' holdings of European general government bonds have decreased, by a total of €102bn, mostly due to Eurozone banks. Analogously, non-eurozone investors have been net buyers of eurozone government debt, but only marginally.

- European banks have been in reduction mode, selling €84bn of their holdings.
- European insurance and pension have decreased their holdings of European general government debt, albeit modestly (€5bn)

- European other financial institutions, households and others sold a total of €14bn in Q2 2017.

- Finally, non-Eurozone investors have increased their exposure to Eurozone general government debt by €37bn. In particular, data suggests that non Eurozone banks increased their holdings by €13bn while Japanese investors and other augmented their exposure by €24bn.

Exhibit 21: European general government debt investor base breakdown Jun-17 vs Mar-17

Investor Base	Jun-17	Mar-17	Change since last quarter
Total Eurozone Holding *	4,102	4,204	-102
Eurozone Banks	1,363	1,447	-84
Eurozone Insurance Pension	1,499	1,503	-5
Eurozone Other Financial Corp	815	826	-12
Eurozone Households	152	157	-5
Eurozone Others	273	270	3
Non-Eurozone Foreign Holdings	2,375	2,338	37
Japanese Investors (Banks Others)	476	478	-2
Non-Eurozone Foreign Banks	374	360	13
Other Non-Eurozone Foreign Holdings	1,525	1,499	26
Net Supply			-49
ECB PSPP+SMP Holding *	1,322	1,209	114
Total Debt Outstanding **	7,799	7,750	49

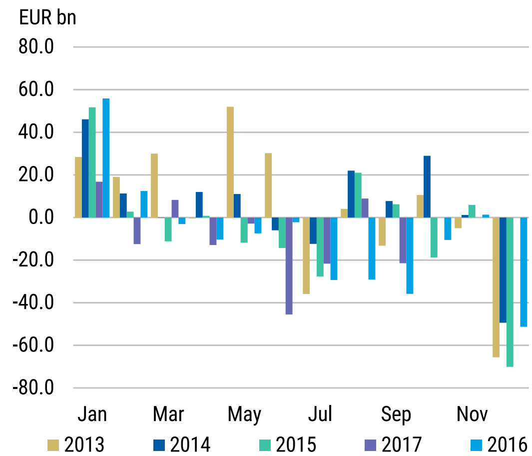
Note: * Total general government debt includes both central and regional government debt. ** Convert from market value to nominal value using weighted average price of each sovereign as of the end of each period. Source: ECB, Eurostat, Japan MoF, BIS, Morgan Stanley Research

European banks continues to reduce exposure to EGB

The main flows in Q2 are attributable to Eurozone banks cutting their exposure to euro sovereigns. As Exhibit 22 suggests, European banks are typically net sellers of govies in Q4 while they are net buyers in Q1. In Q1 17 they repeated the same pattern of purchase, however, despite the support of TLTRO II in Q1, the overall purchase in Q1 17 was less than the average purchase in the last four Q1s, by about €75bn. More interestingly, Q1 17 also coincides with the volatility in sovereign spreads as a result of the French election, which could have slowed down banks' buying power.

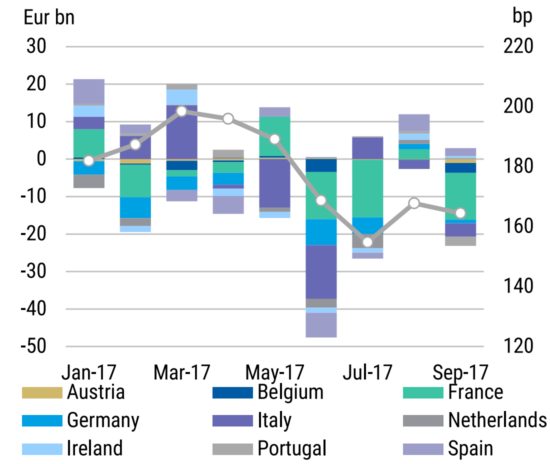
The country breakdown for 2017 (see Exhibit 23) reveals that most of the Q2 selling flows come from Italian and French banks. We think that has been a result of MFIs taking advantage of the attractive valuations in rates and spreads in May and June post the French election to further reduce their sovereign exposure and take profit on the securities they bought in Q1.

Exhibit 22: Europe banks monthly flows of general government debt



Source: Morgan Stanley Research, Bloomberg

Exhibit 23: European banks monthly flow: country breakdown vs BTP-Bund



Source: Morgan Stanley Research, Bloomberg

What the eBMI is telling us?

Our eBMI (see Exhibit13) is more bullish on periphery and semi-core vs. core but now suggests a modest underweight of Italian vs. French sovereigns. The main factor behind its bullish stance on riskier sovereigns remains carry, which is boosted by historically low realized volatility.

Interestingly, the business cycle surprise is increasingly more supportive for BTPs as it reflects a series of better-than-expected economic data. In addition, a solid tightening trend is keeping the momentum factor bullish despite the short term mean reversion component for BTPs which suggests a tactical reversal in the price action.

The FTSE MIB outperformed the DAX in the past 4 months while the CAC 40 underperformed. However, BTPs richness and OAT cheapness vs credit are prevailing over equity markets and keep the factor bullish on semi-core and bearish on periphery. Finally, supply this week has been ~0bn in Germany, ~8bn in France and ~5bn in Italy, which explains the sizeable change in the semi-core signal.

Exhibit 24: Morgan Stanley Euro Sovereign Bond Market Indicators (eBMI)

	Business Cycle Surprises	Momentum	Vol. Adj. Carry	Supply	Risky Assets	Overall
Periphery vs. Core	4.2 (2.9)	1.3 (-0.1)	9.8 (10.0)	7.5 (3.1)	-1.2 (0)	**4.3 (3.2)**
Semi-Core vs. Core	1.0 (1.2)	7.7 (5.9)	4.2 (5.5)	9.6 (-5.4)	2.6 (1.0)	**5.0 (1.6)**
Periphery vs. Semi-Core	1.6 (0.9)	-3.2 (-3.0)	2.8 (2.2)	-1.1 (4.2)	-1.9 (-0.5)	**-0.7 (1.5)**

Source: Morgan Stanley Research
Note: Positive # = long periphery or semi-core vs. core, long periphery vs. semi-core; Negative # = short periphery or semi-core vs. core, short periphery vs. semi-core; (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10.

How to position?

As we have argued in Global Interest Rate Strategist: America's Next Top Fed Chair is... tail-risk of eurozone breakup further diminished and the ECB easing support for longer makes us bullish long peripheral vs core/semi-core sovereigns. We recommend to implement this view on a beta weighted portfolio, with long both Spain and Italy (70:30 weighted) versus France and Germany (25:75) in the 5y sector.

The surprise rating upgrade from S&P on Italy to BBB, despite very little implication for the index, still serves as an indication of the direction of travel for peripheral sovereign ratings given their improved growth outlook and less vulnerable banking sector. Such a trend, which was started with Portugal's upgrade in September (see A Spanish upgrade?), together with a supportive ECB for longer keeps the support for peripheral spread into the year end, in our view.

Trade idea: Hold long BTP Aug-22 and SPGB Apr-22 on 30:70 weight vs short FRTR Mar-23 and OBL Oct-22 on 25:75 weight at 59bp
Trade idea: Hold 5s30s BTP steepener at 253bp

Inflation

United States

In the US, our iBMIs suggest a bullish stance on breakevens, and we believe the best way to express that is in the front-end of the inflation curve. We suggest receiving in 1y1y CPI swaps. Alternatively, we suggest going long Jan19s on a breakeven basis which looks cheap on our relative value metrics. For an expression hedged for oil prices, we suggest buying Apr20s vs. Jul19s.

We look at the recent comments from Fed chair nominee Jerome Powell on inflation. We see Powell's comments on the mystery of inflation as a sign that he may subscribe to Yellen's model based framework which helps understand the mystery of inflation. We believe that Yellen's model based framework still remains operative to understand the Fed's thinking on inflation for now.

Euro area

We remain long 5y BTPei real yields, in line with our lower for longer thesis and sticking with carry trades. The combination of a dovish ECB for the near term and front-end breakevens arguably undervalued relative to our economists' projections should both be supportive to real yields in the front end.

Additionally, we remain cautiously bullish HICPxT inflation via 10s30s flatteners, in spite of the downside surprise to inflation earlier this week. Much of the downside surprise can be attributed to more volatile components of the basket, which do not do a good job of explaining the trend, and our economists' measures of underlying inflation and trimmed means still indicate a gradual upward trajectory. Furthermore, we anticipate long-dated supply into next year will drive long-end weakness on the curve.

Global summary

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Exhibit 25: Morgan Stanley Inflation Bond Market Indicators (iBMI)

	Crude Oil	Momentum	Equities	Value	Average	Overall
TIPS	3.4 (3.3)	6.0 (2.6)	0.8 (0.3)	-1.8 (-1.9)	2.1 (1.1)	**2.1 (1.1)**
UKTi	4.6 (3.9)	4.6 (6.7)	1.3 (0.5)	-4.7 (-4.8)	1.5 (1.6)	**1.5 (1.6)**
HICPxT	4.2 (4.0)	4.7 (7.5)	0.8 (0.2)	-6.2 (-6.2)	0.0 (1.4)	**0.0 (1.4)**
JGBi	3.7 (4.2)	4.0 (4.8)	1.6 (1.4)	3.5 (3.5)	3.2 (3.5)	**3.2 (3.5)**

Source: Morgan Stanley Research
Note: Positive # = long inflation breakeven; Negative # = short inflation breakeven, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.0

Our Inflation Bond Market Indicators (iBMIs) suggest a bullish stance on TIPS, UKTi, and JGBi breakevens, while moving back to neutral on HICP swaps. Oil prices continue their solid run and have continued to be a bullish factor for all regions, with UK registering the strongest reading helped by its currency depreciation. Momentum is also a strong factor supporting breakeven longs in all four regions. Exhibit 25 shows the BMI readings as of Thursday close, November 2.

Equity prices have been more neutral but slightly biased towards supporting breakeven longs, while our slow-moving value factor continues to argue against owning breakevens in all markets but Japan. The poor performance of EM vs DM equity markets has overshadowed the otherwise strong performance of US equities.

The TIPS signal is the strongest long signal, and we see the best expression of that long in the front-end in 1y1y CPI swaps or front-end breakeven longs. In Europe, the HICP swap signal has oscillated between neutral and positive - and we have held a cautiously optimistic view. In the UK, we continue to suggest 10s30s breakeven curve steepener and 10s30s real yield curve flattener. In Japan, we remain medium-term bullish on JGBi breakevens.

United States - What are Powell's views on inflation?

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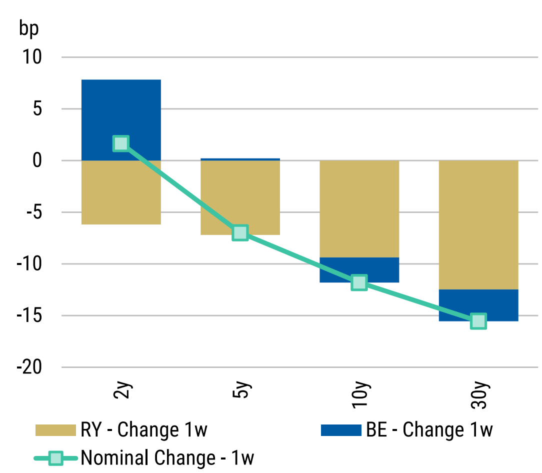
Breakeven recap

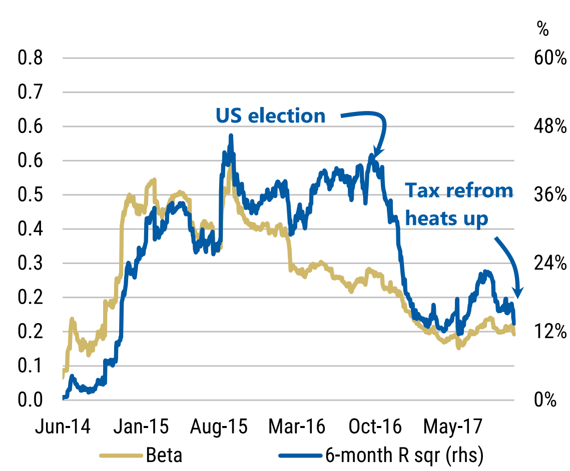
TIPS breakevens had a twist flattening over the week (see Exhibit 26), with breakevens dong well in the front-end as oil prices and prospects of tax reform boosted the near-term inflation outlook, while weak economic data (payrolls, wage growth) and no change in the Fed's stance at the November FOMC meeting have continued to weaken the outlook for longer term inflation. We share the longer- term weak outlook for inflation in the US, while also agree with the outperformance of the front-end.

Exhibit 26: Moves in TIPS real yields and breakevens over the last week



Source: Bloomberg, Morgan Stanley Research

Exhibit 27: Rolling 6m correlation between 5-year breakeven and oil price changes

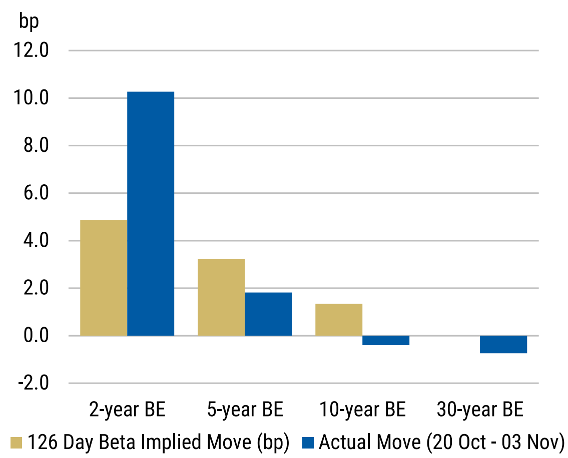


Source: Bloomberg, Morgan Stanley Research

Oil prices have limited impact: The importance of oil prices in driving breakevens has decreased, in our opinion - as news from the new US administration takes center stage once again. The big drivers in recent times have been prospects of tax reform, as well as the new Fed chair announcement - making the impact of oil prices minimal beyond the very front-end. The correlation between oil prices and breakevens dipped after the US elections, and has dipped again recently as tax reform headlines have dominated news.

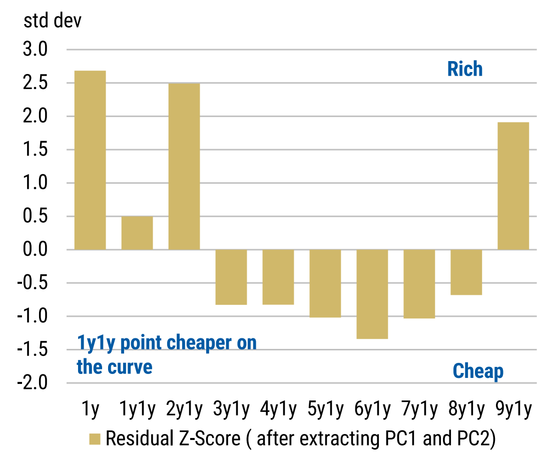
Front-end breakevens most responsive to tax reform: Comparing the actual moves in breakevens to beta-implied moves based on the last six months of relationships (see Exhibit 28), 2-year breakevens have outperformed the moves in oil, while 5-, 10- and 30-year have underperformed. While the weakness in longer term breakevens, and the lack of response to oil prices in general is understandable, the outperformance of 2-year breakevens shows the potential impact of the tax reform headlines, in our view.

Exhibit 28: Change in breakevens vs. 6m oil beta implied moves



Source: Bloomberg, Morgan Stanley Research

Exhibit 29: PCA residual z-scores to select the richest and cheapest points on the CPI swap curve



Source: Bloomberg, Morgan Stanley Research

Continue front-end inflation exposure: We continue to suggest 1y1y inflation swaps as the best way to play the long breakeven signal from our iBMIs, along with the prospects of tax reform, especially given the relative cheapness of the 2y sector in CPI swaps in the front-end. We also look at the best way to play the same trade in TIPS bonds - by buying 2.125 Jan19s on a breakeven basis (see Exhibit 30 for relative value screening).

A purer way to play for tax reform would be to create a breakeven forward with equal notional amounts such that the impact of oil prices on the overall trade is minimized. One way of doing that would be to position long breakevens in April20s and July19s, which effectively hedges the exposure of the breakeven to oil prices, but plays for a rise in short-term inflation over the next 2 years.

Exhibit 30: Screen for relative value based on forward breakevens as well as TIPS real yield spline (red: rich,; green: cheap)

Name	Fwd Breakeven	3m Z-score	Rich/Cheap (bp)	R/C 3m Z-score
1.625 Jan18s	171	0.63	-0.8	-1.9
0.125 Apr18s	114	0.61	-2.5	1.8
1.375 Jul18s			1.5	-2.0
2.125 Jan19s	177	2.69	0.4	1.8
0.125 Apr19s	180	1.94	-2.0	1.9
1.875 Jul19s	189	2.02	0.9	-1.9
1.375 Jan20s	184	2.04	-0.2	-1.0
0.125 Apr20s	185	1.64	-1.1	1.1
1.250 Jul20s	179	-0.36	2.2	-1.6
1.125 Jan21s	188	0.07	-1.3	0.7
0.125 Apr21s	185	0.58	-1.1	-0.5
0.625 Jul21s	192	-1.18	1.7	1.1
0.125 Jan22s	181	-1.18	0.3	1.8
0.125 Apr22s	201	-0.76	-1.7	-0.6
0.125 Jul22s	186	0.20	0.2	-1.9
0.125 Jan23s	195	0.95	0.5	-0.7
0.375 Jul23s	186	-0.87	0.1	1.2
0.625 Jan24s	183	0.49	-0.1	0.1
0.125 Jul24s	185	0.68	-0.6	1.3
0.250 Jan25s	182	-0.11	-1.2	-0.8
2.375 Jan25s	135	1.98	1.1	-2.4
0.375 Jul25s	208	-0.62	-0.4	0.4
2.000 Jan26s	172	-2.71	2.0	-1.1
0.625 Jan26s	229	-3.43	-0.2	-0.1
0.125 Jul26s	145	1.67	-0.3	0.3
2.375 Jan27s	109	-0.99	1.8	1.6
0.375 Jan27s	176	-0.48	-1.0	1.4
0.375 Jul27s	188	-0.54	-2.0	1.6
1.750 Jan28s	116	0.54	-0.8	-1.4
3.625 Apr28s	176	0.89	0.8	-3.2
2.500 Jan29s	182	-2.31	0.4	-1.5
3.875 Apr29s	131	-2.97	2.5	-1.0
3.375 Apr32s	183	-1.45	-2.6	1.5
2.125 Feb40s	188	0.61	0.6	-2.0
2.125 Feb41s	202	0.23	0.7	-1.0
0.750 Feb42s	227	1.27	-0.6	0.3
0.625 Feb43s	213	-2.36	-0.9	1.3
1.375 Feb44s	154	1.73	1.0	-2.1
0.750 Feb45s	263	-0.71	-0.4	-0.8
1.000 Feb46s	220	1.63	0.3	-2.3
0.875 Feb47s	193	-1.22	-0.2	0.8

Source: Bloomberg, Morgan Stanley Research

Oil prices have limited impact: The importance of oil prices in driving breakevens has decreased, in our opinion - as news from the new US administration takes center stage once again. The big drivers in recent times have been prospects of tax reform, as well as the new Fed chair announcement - making the impact of oil prices minimal beyond the very front-end. The correlation between oil prices and breakevens dipped after the US elections, and has dipped again recently as tax reform headlines have dominated news.

Powell's views on inflation

With Jerome Powell now officially nominated by President Trump as the next Fed chair, the market will look for clues on how and whether he plans to change the direction of monetary policy from the path in recent years. Is Yellen's framework on inflation still valid - and if so - will Powell continue to keep the Fed on a tightening path even amid low inflation?

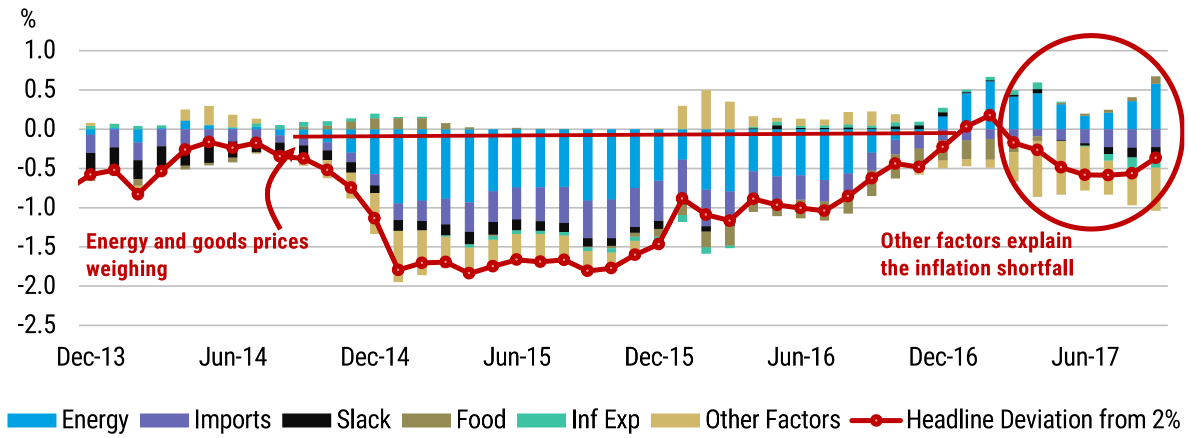
> ***Powell to CNBC (Aug 25, 2017):*** *Inflation is a little bit below target, and it's kind of a mystery. You would have expected given that we're getting tighter labor markets that we'd have a little higher inflation. I think that what that gives us is the ability to be patient.*

Our Economists published a note summarizing recent comments from Jerome Powell on monetary policy, labor market, financial stability, as well as inflation. Most interestingly, his comments on inflation echo the recent comments from Yellen on inflation. Yellen has called the recent drop in inflation a "mystery", with Powell saying something similar in an interview to CNBC recently.

We have recently correlated the "mystery" in Yellen's comments to the attribution breakdown in Yellen's inflation model, where "other factors" explain the majority of the down moves in inflation this year. We think that model and framework may still hold relevance under a Powell Fed given his characterization of mystery of inflation.

The FOMC statements have echoed the conclusions of the inflation model that Yellen introduced in her speech in 2015, suggesting a broader acceptance of the Yellen framework within the FOMC. For example - the FOMC statement introduced the drags from oil prices and goods prices as "transitory" factors affecting inflation in October 2014, when the model suggested a 15-20bp drag from these factors, and took out the reference when the drag reduced back to 15-20bp in January 2017 FOMC statement (see Exhibit 31).

Exhibit 31: Attribution of various factors to shortfall/rise in headline PCE inflation vs. its 2% target



Source: Bloomberg, Morgan Stanley Research

Trade idea: Receive in 1y1y CPI swap;
Long 0.625 Jan19s breakeven;
Buy Apr20s Breakeven vs. Sell Jul19s Breakeven in equal notionals

Euro area - Cautiously bullish Euro inflation

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Lower for Longer

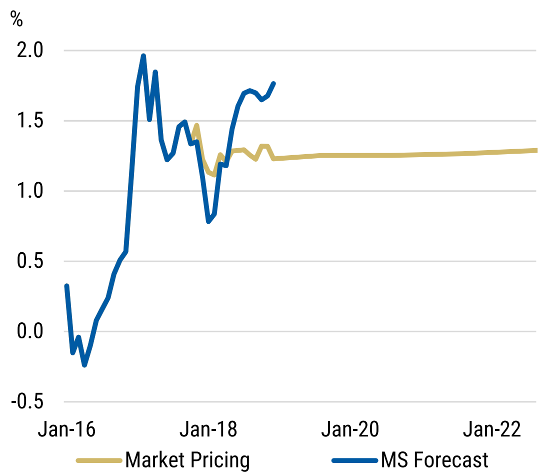
After the dovish tone of the ECB last week, we maintain our positions in 5y real yields, in line with our lower-for-longer thesis. We like to express the view via BTPei-22s as they have an attractive carry profile (47bp over the next 12 months), and we see limited risk of a sovereign credit issue in the near term.

We think that inflation markets are underpricing the path of inflation recovery, particularly relative to our economists' forecasts (Exhibit 32). At the same time, the dovish stance of the ECB and their concern about euro strength means their path of monetary policy normalization is likely to be gradual and limited in scope. Furthermore, fewer purchases for longer has already had the effect of pushing out the timing of lift-off. Accommodative monetary policy should be support breakevens in the front end.

Real yields should hence continue to richen for two reasons – first, the nominal curve pricing less in the way of policy normalization, and second, the breakeven richening we expect to see on the back of the gradual recovery of core inflation our economists expect.

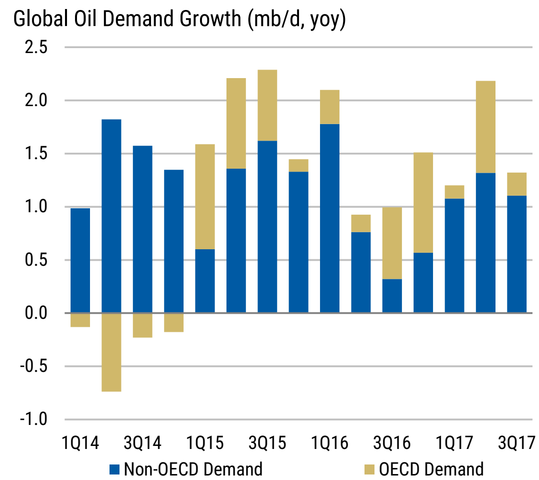
The risks to our trade include a sudden unanticipated hawkish turn by the ECB, and continued downside surprises to euro area inflation over and above the expected negative impact of energy base effects into 1Q18.

Exhibit 32: Euro HICPxT: MS forecasts and market pricing



Source: Morgan Stanley Research, BGC

Exhibit 33: Global oil demand growth



Source: Morgan Stanley Research, IEA

Downside surprise, but still cautiously bullish

Despite the downside surprise to inflation this week, we maintain our cautiously bullish stance in euro area inflation via directionally neutral 10s30s flatteners. Our economists primarily attribute the downtick to one-off idiosyncratic factors, such as cuts in Italian university fees, as well as volatile components of the core basket, such as package holidays and airfares, which do not do a good job of explaining the underlying trend. Our economists' measures of super-core inflation and trimmed-mean inflation still point towards an underlying trend of a gradual uptick in core inflation.

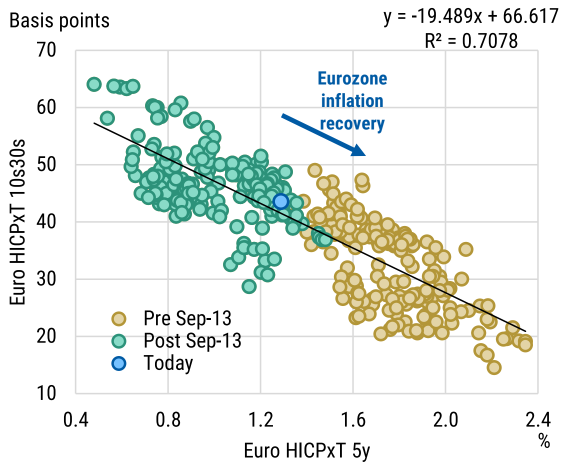
Our iBMIs have shifted back to neutral on euro area inflation after a brief week in bullish territory, because the oil-and-momentum-driven rally caused the value signal to push further bearish. However, value is the slowest-moving factor of our iBMIs and has been suggesting a bearish stance in euro area inflation for some time, given the 5y look-back period, a period in which realized inflation was incredibly low.

Furthermore, the rally in oil, which has contributed to the global breakeven rally in the past quarter, has been demand-driven rather than supply-driven (Exhibit 33). There has been noise around OPEC lately, especially in the lead-up to the November meeting, but we suspect that even if OPEC manages to disappoint market expectations of further agreements, the fundamental global growth picture is robust, and should continue to drive demand for the product, and indirectly, breakevens.

Supply picture supportive

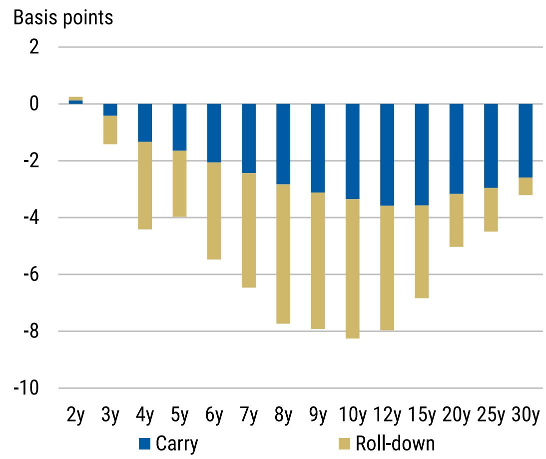
This year was the year of 10y benchmarks, and contributed to 10y HICPxT weakness through the first half of this year. Idiosyncratic selling flows in 5y5y then served to prevent 10y from bouncing through the summer. Now that we are through these events, we expect the belly of the curve to find more support, especially into year-end as the auction calendar comes to a close.

Exhibit 34: 10s30s HICPxT given levels of 5y



Source: Morgan Stanley Research, Bloomberg

Exhibit 35: HICPxT carry and roll-down profile



Source: Morgan Stanley Research, Bloomberg

There is also reasonable expectation of a new 30y BTPei benchmark sometime next year, and the possibility that Spain may continue to build out their curve by issuing a 30y benchmark of their own. The anticipation of these two high duration-supply events should start to weigh on the back end of the HICPxT term structure into next year. The long end of the curve has arguably stayed elevated through this year because of the relative lack of long-dated supply, and this is likely to change.

Unfortunately, the belly of the curve is the worst part of the curve to go long from a carry and roll perspective (Exhibit 35). The carry of the trade can be improved by flattening 10s20s instead, for example. However, the improvement is marginal, and we feel that the factors we identify as likely to drive the flattening will more directly influence the 10y and 30y tenors.

The risk to our trade is a series of downside surprises to euro area inflation, which would drive the front end to sell off and the curve to steepen.

Trade idea: Hold long BTPei-22 real yield at -0.44%
Trade idea: Hold 10s30s HICPxT flattener at 44bp

Money Markets

United States

The TBAC's 2018 UST issuance recommendations led to steepening of the swap spread curve since they emphasized issuance in the front end of the curve. We expect the T-bill issuance in 2018 to be even higher than what the TBAC has recommended over the long run. As a result, repo rates are likely to face upward pressure and 2y spreads will likely continue tightening.

While 30y spreads benefited (i.e., widened) from the TBAC's announcement, we caution investors against putting on wideners on 30y spreads, and we prefer 10y spread wideners instead. 10y spread wideners benefit from the likely 2018 issuance mix and offer protection in a flight-to-quality scenario. 30y spreads, however, could tighten strongly in a risk-off scenario as LDIs add duration through receiving in 30y swaps. Additionally, the carry and roll on 10y spread wideners is more positive than on 30y.

United States - Sticking with swap spread curve steepeners

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1y1y FRA-OIS Recap

We continue to have high conviction in 1y1y FRA-OIS tighteners, particularly in conjunction with a 5y swap spread or invoice spread widener. We discuss the trade in detail in America's Next Top Fed Chair is... and in Waiting for Reflation with Flatteners.

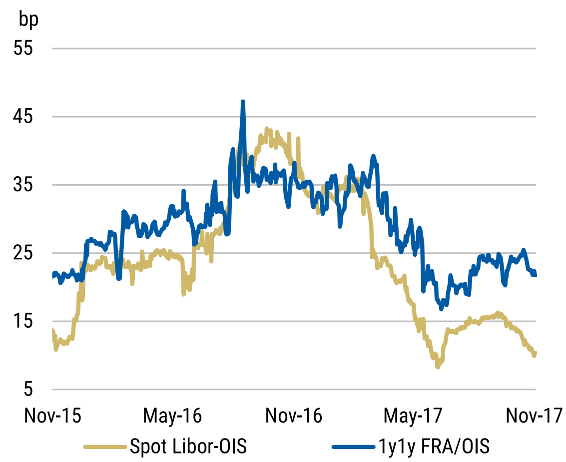
In short, the trade carries well (better than 10y USTs), it offers risk-off protection, positions for the continued flow of AUM into MMFs, and benefits from the removal of FDIC surcharge in 2018 that is likely to structurally tighten FRA-OIS. Exhibit 36 shows how 1y1y FRA-OIS remains wide relative to spot Libor-OIS, which it eventually rolls to.

TBAC and the Swap Spread Curve

We also continue to like 2s5s swap spread steepeners. We believe the recent Treasury refunding statement is supportive of further steepening in the swap spread curve. Exhibit 37 shows that the steepening that followed the statement was most pronounced in the 2s30s swap spread curve. This was in part because the 30y swap spread benefited from the lack of mention of ultra-long issuance.

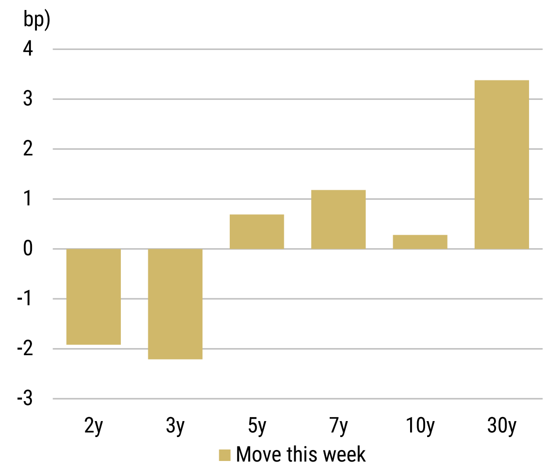
2y and 3y swap spreads, on the other hand, tightened as a result of the TBAC's recommendation that new issuance next year be focused on T-bills and 2s, 3s, and 5s coupon USTs.

Exhibit 36: 1y1y FRA-OIS vs Spot Libor-OIS



Source: Morgan Stanley Research, Bloomberg

Exhibit 37: Move in swap spreads over the past week



Source: Morgan Stanley Research, Bloomberg

Will the swap spread curve move continue?
We believe the move in 2y swap spread will continue and it is likely to end the year at tighter levels. We discussed a number of drivers for the tightening in the USD Liquidity into Year-End piece. In short, the tight Libor-Repo spread in the front end relative to 2y swap spreads is likely to keep 2y spreads pressured.

Additionally, **as we discussed in the United States - TBAC, JCT and the issuance outlook section above, we expect the T-bill issuance next year to exceed market expectations given the shortage of T-bills in the market, which would require more focus on T-bill issuance**. This is likely to put upward pressure on GC repo rates which in turn pressures 2y spreads.

As for 5y spreads, while they might face downward pressure from increased issuance in the 5y note next year, we think the pressure would be less than that on the 2y note. Additionally, the 5y spreads are likely to remain supported by other factors:

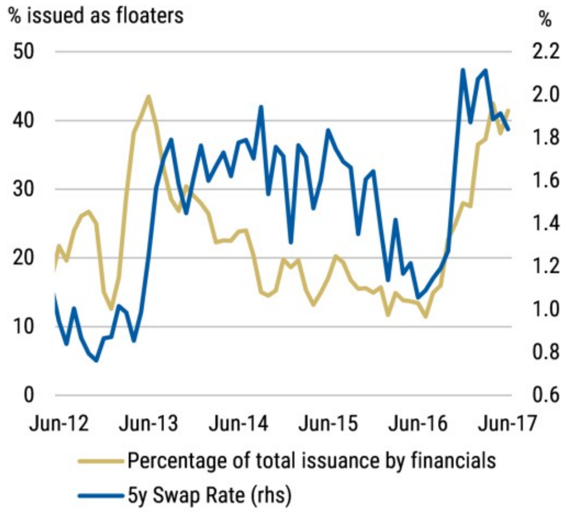
1. 5y spread wideners have the best positive carry on the spread curve (see Exhibit 39).

2. Floating coupon issuance by financial corporations remains elevated relative to history (see Exhibit 38). This reduces the pressure on belly spreads from fixed-to-floating swapping activity.

3. With Randal Quarles officially filling the Fed Vice Chair for Supervision role, we are likely to start seeing more headlines on potential deregulatory measures. The fact that the nominated next Fed Chair, Jerome Powell, is supportive of some regulatory easing adds to the likelihood of progress on that front. Easing of leverage ratios such as SLR would be supportive of spreads that are trading below fundamental value.

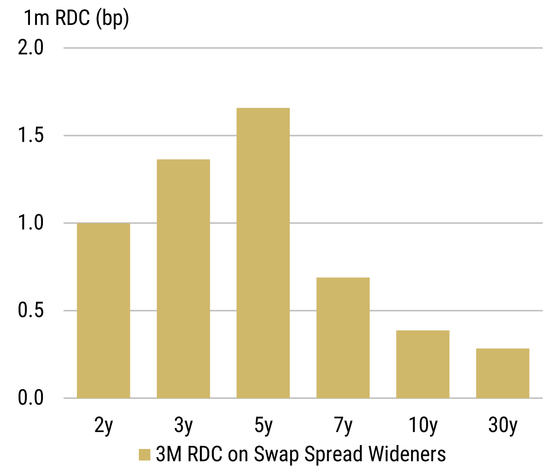
4. Belly spread wideners offers protection in a risk-off scenario that increases demand on Treasuries.

Exhibit 38: Percentage of financial corporate issuance as floating rate notes



Source: Morgan Stanley Research, Bloomberg

Exhibit 39: 1-month carry and roll on swap spread wideners



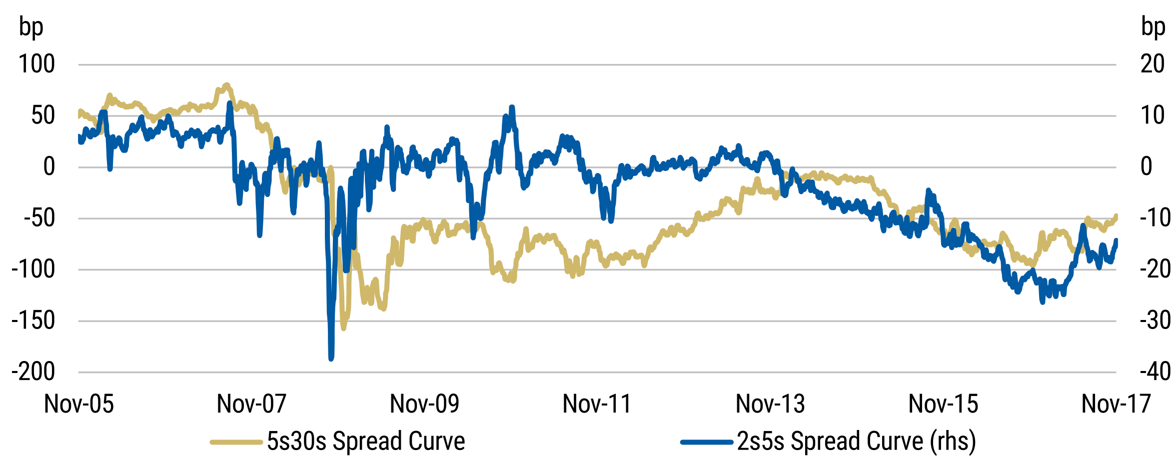
Source: Morgan Stanley Research
Note: Carry numbers use the term repo rates to the end of November

What about 30y spreads?

As for 30y swap spreads, we think they could also continue to widen as a result of the 2018 issuance mixture as well as the potential for deregulation. However, 30y spreads are at risk of large tightening moves in a risk-off event. This is a result of swap-receiving activity by the LDI community and variable annuity managers that add duration to their portfolios in times of stress through receiving in 30y swap spreads.

The 30y swap receiving demand is most pronounced when equities are falling. As Exhibit 40 shows, this results in a breakdown of correlation between the slope of the 2s5s (or the 2s10s) swap spread curve and the 5s30s swap spread curve.

Exhibit 40: 5s30s and 2s5s swap spread curve history



Source: Morgan Stanley Research, Bloomberg

In short, we prefer owning 10y spreads rather than 30y spreads as a way to benefit form the potential continued steepening in the swap spread curve. 10y spread wideners benefit from the arguments we provided above for being long 5y swap spreads as well as the coupon UST issuance mix recommended by the treasury. However, unlike 30y spreads they actually offer risk off protection in a flight-to-quality move.

The risk to the 10y swap spread widener, as well as the 5y spread widener, is an increase in fixed coupon issuance by financials, which then gets swapped into floating coupon, pressuring belly swap spreads down.

Trade idea: Maintain 1y1y FRA-OIS spread tightener at 21.5bp
Trade idea: Maintain 2y swap spread tightener at 20.93bp
Trade idea: Maintain 5y swap spread widener at 7.5bp
Trade idea: Enter 10y swap spread widener at -2bp

Derivatives

United States

Rates volatility collapsed this week as the market struggled to find any meaningful information follow-through to take rates higher. Everything the market has been waiting for has come and passed. We think it's time to focus on carry trades for the rest of the year. We continue to like distributional trades with positive carry such as the 6m10y payer ladder and the 1y1y cap vs swaption wedge. Also as a tail hedge for a "no hike" scenario, we like EDZ7 99.625 calls at 0.5c. It can return up to 20x, much better risk / reward than receiving OIS at ~85%.

United States - Vol keeps on fallin'

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Vols collapse after a disappointing week of realizeds

After a brief spike ahead of an event-filled week, volatility collapsed as the market struggled to find any meaningful information follow-through to take rates higher. Both the appointment of the new Fed chair and the proposal for tax reform came and passed without any fireworks. Meanwhile, the Bank of England's first rate hike in a decade was met with skepticism regarding the pace of future hikes. Governor Carney's dovish tone took UK 5y rates 9 bps lower on the day of a rate hike.

All of this in concert gave vol sellers comfort to resume their strategies this week. Exhibit 41 shows the weekly change of the implied vol surface. Gamma, in particular, got hit down especially hard as the market absorbed the selling flows. Even though we're at new all-time lows, it's tough to see what's left in 2017 that can take vols higher. Everything the market has been waiting for has come and passed. We think it's time to focus on carry trades for the rest of the year.

Exhibit 41: Swaption vol change over week (bp vol)

Expiry	1Yr	2Yr	3Yr	4Yr	5Yr	6Yr	7Yr	10Yr	20Yr	30Yr
1Mo	(8.6)	(8.5)	(8.5)	(11.0)	(11.9)	(10.4)	(9.9)	(7.8)	(8.6)	(7.8)
3Mo	(4.2)	(6.4)	(5.7)	(8.4)	(9.1)	(7.2)	(7.3)	(7.0)	(6.3)	(6.4)
6Mo	(5.4)	(5.3)	(5.4)	(6.6)	(7.2)	(6.9)	(6.1)	(6.0)	(6.0)	(6.3)
9Mo	(4.5)	(5.0)	(5.5)	(6.4)	(7.7)	(7.3)	(7.0)	(6.0)	(5.6)	(5.8)
1Yr	(4.6)	(5.0)	(5.2)	(4.6)	(5.5)	(5.2)	(5.0)	(4.8)	(4.4)	(4.6)
2Yr	(3.2)	(2.7)	(3.1)	(2.9)	(3.1)	(3.0)	(3.2)	(2.5)	(3.1)	(3.0)
3Yr	(1.8)	(2.8)	(2.3)	(2.4)	(2.1)	(2.1)	(1.9)	(2.1)	(2.3)	(2.1)
4Yr	(2.7)	(2.1)	(1.7)	(1.7)	(2.0)	(2.2)	(1.9)	(1.9)	(1.7)	(1.6)
5Yr	(2.2)	(1.1)	(1.8)	(1.8)	(1.3)	(1.5)	(1.4)	(1.1)	(1.3)	(0.9)
10Yr	(0.5)	(0.1)	0.0	(0.2)	(0.4)	0.0	0.0	(0.3)	(0.6)	(0.2)

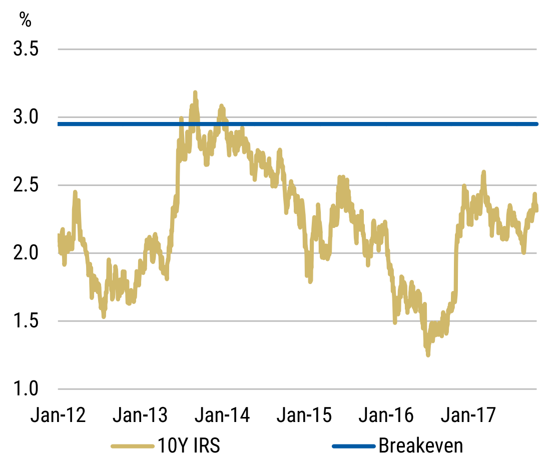
Source: Morgan Stanley Research

Distribution trades remain in vogue

It seems that all of the information that could have taken rates higher has already come out. We think rates should remain range bound into year end and distributional trades continue to make sense. From our last weekly America's Next Top Fed Chair is..., we recommended: 1) 6m10y payer ladder and 2) 1y1y cap vs swaption wedge. We think both trades still look attractive, especially to position for the terminal distribution of rates. Exhibit 42 and Exhibit 43 show the breakeven range vs the underlying rates for the payer ladder and wedge, respectively.

The upper breakeven range on the 10y swap rate is 2.95%, which is a level not breached since the taper tantrum. As for the wedge, the breakeven range is slightly higher than the current forward. However, as the Fed continues to hike, we think the Dec18 1y forward should continue to drift higher, but not break out beyond the range.

Exhibit 42: Payer ladder breakeven vs 10y rate



Source: Morgan Stanley Research

Exhibit 43: Wedge breakeven vs Dec18 forward

Source: Morgan Stanley Research

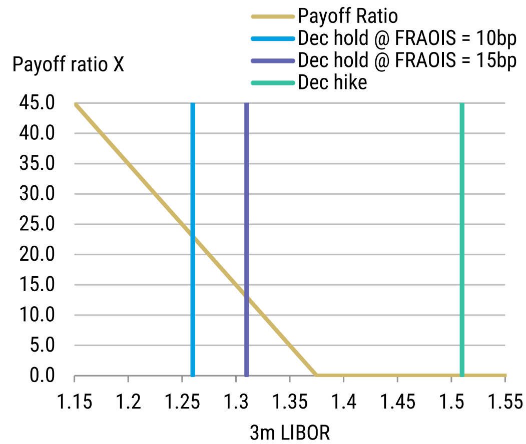
Simple but levered hedge for a December "no hike"

Sometimes the best structure is the simplest one. EDZ7 98.625 calls are now 0.5c offered in the market. Exhibit 44 shows the recent move down. That basically suggests that the market has almost entirely written off a Fed "on hold" outcome in December. We think this is a very cheap option for investors who want to hedge that scenario. Depending on the FRA/OIS, this trade can return approximately 10x to 20x (Exhibit 45). Relative to receiving OIS swaps at ~85%, this has much better risk / reward.

Exhibit 44: Z7 98.625 call price history

Source: Bloomberg

Exhibit 45: Payoff ratio vs 3mL



Source: Morgan Stanley Research

Trade idea: EDZ7 98.625 Call for 0.5c

Supply

In the US, new 3y, 10y, 30y USTs will be issued for a total of $62bn. These will settle in the week after next when $36bn coupons and $54bn redemptions will be paid. **In the euro area,** we expect €5bn of nominal supply (from Austria, Germany, Ireland) against no coupons and redemptions. Average gross nominal supply for the same week of the past three years is €17bn. **In the UK,** UKT 0.75% Gilt 2023 will be tapped for £2.75bn, against no cash flow. In addition, New UKTi 0.125% Gilt 2048 will be launched via syndication for an estimated £4bn. **In Japan,** 30y JGB will be issued for ¥0.8trn, against no cash flow. In addition, there will be an auction for enhanced liquidity for ¥0.3trn. **In Canada,** GCAN 1.75% Mar 2023 will be tapped for $3.7bn against no cash flow. **In Australia,** ACGB 3.75% Apr 2037 will be issued for $400mn, ACGB 2.25% Nov 2022 for $1500mn and ACGB 2.75% Nov 2027 for $900mn, against no cash flow. **In New Zealand,** there will be no nominal supply or cash coming into the market.

Exhibit 46: Sovereign supply calendar

Monday	Tuesday	Wednesday	Thursday	Friday
6-Nov	7-Nov	8-Nov	9-Nov	10-Nov
**UK: New UKTi 0.125% Gilt 2048 via Syndication, £4bn* AUS: ACGB 3.75% Apr 2037 Tap, $400mn	AUT: RAGB Auction Tap, €1.15bn RAGB 0.5% Apr 2027, RAGB 0% Sep 2022 JPN: Auction for Enhanced-liquidity, ¥300bn US: New 3y UST, $24bn GER: DBRi 0.5% Apr 2030 Tap, €0.5bn	ITA: BTP Announcement GER: OBL Oct 2022 Tap, €3bn US: New 10y UST, $23bn CAN: GCAN 1.75% Mar 2023 Tap, $3.7bn AUS: ACGB 2.25% Nov 2022 Tap, $1500mn	UK: UKT 0.75% Gilt 2023 Tap, £2.75bn JPN: 30y JGB Auction, ¥800bn US: New 30y UST, $15bn IRE: IRISH Bond auction, $1bn*	AUS: ACGB 2.75% Nov 2027 Tap, $900mn
13-Nov	14-Nov	15-Nov	16-Nov	17-Nov
ITA: BTP Auction, €6bn*	GER: New BKO Dec 2019, €5bn JPN: 5y JGB Auction, ¥2200bn* NETH: DSL 0.75% July 2027 Tap, €2-3bn* AUS: ACGB I/L Auction, $150mn*	GER: DBR Aug 2027 Tap, €3bn CAN: 3y GCAN, $3.3bn* AUS: ACGB Auction $800mn*	SPA: SPGB Auction, €5bn* FRA: Medium term auction, €7-8bn*| FRA: Index linked auction, €1-1.5bn* UK: UKT 1.25% Gilt 2027 Tap, £2.5bn* JPN: 20y JGB Auction, ¥1000bn* US: 10y TIPS Re-opening, $11bn* NZ: NZGB 2.75% Apr 2025 Tap, $200mn	AUS: ACGB Auction $800mn*
20-Nov	21-Nov	22-Nov	23-Nov	24-Nov
BEL: OLO Auction, €2-3bn*	UK: UKTi 0.125% Gilt 2026 Tap, £1bn* JPN: Auction for Enhanced-liquidity, ¥500bn* US: 2y FRN Reopening, $13bn*	ITA: BTPei Announcement ITA: CTZ Announcement GER: DBR Aug 2048 Tap, €1bn CAN: 2y GCAN, $3.9bn* AUS: ACGB Auction $800mn*	NZ: NZGB 3.5% Apr 2033 Tap, $150mn	ITA: BTP Announcement AUS: ACGB Auction $800mn*

Source: Morgan Stanley Research, Treasuries
* Morgan Stanley estimate. ** The syndication is scheduled to take place in the week beginning 6th November

We gratefully acknowledge the contribution of Asmita Jimulia to this section of the report.

Bond Market Indicators

Latest readings

Exhibit 47: Morgan Stanley Bond Market Indicators - BMI(10)

	Vol Adj. Carry	Momentum	Equity Markets	Business Cycle	FX/Rates	Average	Overall
UST	-3.7 (-1.8)	-7.9 (-5.1)	-1.2 (0.0)	-6.0 (-6.3)	-2.5 (0.8)	-4.3 (-2.5)	**0.0 (-2.5)**
DBR	4.8 (5.4)	1.9 (4.7)	-1.6 (-0.3)	-1.9 (-3.0)	-5.7 (-4.6)	-0.5 (0.4)	**0.0 (0.0)**
UKT	2.9 (4.2)	-6.2 (-1.9)	-2.2 (-0.4)	-0.3 (-2.2)	4.2 (3.4)	-0.3 (0.6)	**0.0 (0.0)**
JGB	0.4 (0.2)	0.9 (-6.4)	-4.0 (-3.6)	-4.0 (-4.0)	2.1 (-0.4)	-0.9 (-2.8)	**0.0 (-2.8)**
ACGB	8.2 (9.2)	-0.3 (-3.1)	-3.8 (-1.1)	-0.4 (-0.9)	-5.3 (-2.1)	-0.3 (0.4)	**0.0 (0.0)**
NZGB	6.6 (7.8)	-1.9 (2.7)	-1.5 (-0.6)	3.2 (-3.0)	3.7 (6.3)	2.0 (2.6)	**0.0 (0.0)**
CAN	-6.1 (-5.1)	-2.6 (-1.6)	-1.6 (-2.2)	-2.7 (3.3)	-1.9 (-5.2)	-3.0 (-2.2)	**0.0 (-2.2)**

Source: Morgan Stanley Research
Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5

Exhibit 48: Morgan Stanley Bond Market Indicators - BMI(2)

	Vol Adj. Carry	Momentum	Equity Markets	Business Cycle	FX/Rates	Average	Overall
UST	5.6 (7.2)	-9.5 (-9.6)	-1.2 (0.0)	-6.0 (-6.3)	3.0 (1.5)	-1.6 (-1.4)	**-1.6 (0.0)**
DBR	-6.0 (-5.2)	3.6 (4.7)	-1.6 (-0.3)	-1.9 (-3.0)	-3.7 (-2.4)	-1.9 (-1.2)	**-1.9 (0.0)**
UKT	2.4 (5.4)	-7.9 (-5.4)	-2.2 (-0.4)	-0.3 (-2.2)	0.5 (2.9)	-1.5 (0.1)	**0.0 (0.0)**
JGB	-5.7 (-4.9)	4.9 (5.6)	-4.0 (-3.6)	-4.0 (-4.0)	-4.6 (-4.0)	-2.7 (-2.2)	**-2.7 (0.0)**
ACGB	5.3 (7.9)	0.3 (-5.2)	-3.8 (-1.1)	-0.4 (-0.9)	-5.8 (-2.2)	-0.9 (-0.3)	**0.0 (0.0)**
NZGB	3.9 (4.5)	3.3 (2.5)	-1.5 (-0.6)	3.2 (-3.0)	3.5 (4.1)	2.5 (1.5)	**0.0 (0.0)**
CAN	-0.3 (0.2)	-3.6 (-3.4)	-1.6 (-2.2)	-2.7 (3.3)	-0.2 (-1.3)	-1.7 (-0.7)	**-1.7 (0.0)**

Source: Morgan Stanley Research
Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5

Exhibit 49: Morgan Stanley Bond Market Indicators - xBMIs

	DBR/UKT	DBR/JGB	DBR/UST	UKT/JGB	UKT/UST	JGB/UST
Overall Signal	**0.0 (0.0)**	**0.0 (0.0)**	**0.0 (0.0)**	**0.0 (3.1)**	**3.6 (0.0)**	**3.3 (0.0)**
Average xBMI	-4.0 (-4.4)	-1.8 (-0.5)	2.0 (-0.3)	0.5 (3.1)	3.6 (2.0)	3.3 (-0.8)
combined BMI differential	0.0 (0.0)	0.0 (2.8)	4.3 (2.5)	0.0 (2.8)	4.3 (2.5)	4.3 (-0.4)
FX/Rates	-7.9 (-8.8)	-3.6 (-3.8)	-0.3 (-3.0)	1.0 (3.3)	3.0 (1.5)	2.4 (-1.2)
	ACGB/NZGB	**ACGB/CAN**	**ACGB/UST**	**NZGB/CAN**	**NZGB/UST**	**CAN/UST**
Overall Signal	**0.0 (-2.4)**	**0.0 (0.0)**	**0.0 (0.0)**	**2.5 (4.5)**	**3.1 (2.6)**	**0.0 (0.0)**
Average xBMI	-3.7 (-2.4)	0.4 (1.1)	-0.3 (0.1)	3.6 (4.5)	1.9 (0.6)	-0.4 (-0.2)
combined BMI differential	-2.0 (-2.6)	3.0 (2.2)	4.3 (2.5)	5.0 (4.8)	6.3 (5.1)	1.3 (0.3)
FX/Rates	-5.4 (-2.2)	-2.2 (0.0)	-4.9 (-2.2)	2.3 (4.1)	-2.5 (-3.9)	-2.0 (-0.7)

Source: Morgan Stanley Research
Note: Positive # = long cross market spreads; Negative # = short cross market spread, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -15 and +15, Signal is calculated as the average of Combined BMI differential and the FX component. Signal is set to zero if abs(Signal)<=2 and/or its has a sign different from the Combined BMI differential

How to read the xBMIs

The "FX/Rates" row displays the FX/rates relationship signal. The "Combined BMI differential" row displays the difference between the relevant BMI(10) signals after having applied the signal strength check, i.e., abs(signal) >= 1.5. The "Average xBMI" row displays the average of the "FX/Rates" and "Combined BMI differential" rows. And the "Overall" score requires that the sign of the "Average xBMI" signal match the sign of the "Combined BMI differential" signal and be ≥ the absolute value of 2.

Exhibit 50: Morgan Stanley Euro Sovereign Bond Market Indicators - eBMI

	Business Cycle Surprises	Momentum	Vol. Adj. Carry	Supply	Risky Assets	Overall
Periphery vs. Core	4.2 (2.9)	1.3 (-0.1)	9.8 (10.0)	7.5 (3.1)	-1.2 (0)	**4.3 (3.2)**
Semi-Core vs. Core	1.0 (1.2)	7.7 (5.9)	4.2 (5.5)	9.6 (-5.4)	2.6 (1.0)	**5.0 (1.6)**
Periphery vs. Semi-Core	1.6 (0.9)	-3.2 (-3.0)	2.8 (2.2)	-1.1 (4.2)	-1.9 (-0.5)	**-0.7 (1.5)**

Source: Morgan Stanley Research
Note: Positive # = long spreads; Negative # = short spreads, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10.

Exhibit 51: Morgan Stanley Inflation Bond Market Indicators - iBMI

	Crude Oil	Momentum	Equities	Value	Average	Overall
TIPS	3.4 (3.3)	6.0 (2.6)	0.8 (0.3)	-1.8 (-1.9)	2.1 (1.1)	**2.1 (1.1)**
UKTi	4.6 (3.9)	4.6 (6.7)	1.3 (0.5)	-4.7 (-4.8)	1.5 (1.6)	**1.5 (1.6)**
HICPxT	4.2 (4.0)	4.7 (7.5)	0.8 (0.2)	-6.2 (-6.2)	0.0 (1.4)	**0.0 (1.4)**
JGBi	3.7 (4.2)	4.0 (4.8)	1.6 (1.4)	3.5 (3.5)	3.2 (3.5)	**3.2 (3.5)**

Source: Morgan Stanley Research
Note: Positive # = long inflation breakeven; Negative # = short inflation breakeven, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.0

Performance history

Exhibit 52: Morgan Stanley Bond Market Indicators - BMI(10) - Performance history

	UST	DBR	UKT	JGB	ACGB	NZGB	CAN
1-Week Return	-2.0%	0.0%	0.0%	-0.7%	0.0%	0.0%	-1.2%
YTD Return	-6.1%	-0.9%	-9.2%	0.0%	-6.3%	2.1%	-3.3%
1-Year Return	-0.5%	2.7%	-11.5%	8.3%	-7.2%	5.1%	12.8%
1-Year Return Vol	0.17	0.10	0.18	0.12	0.12	0.04	0.23
1-Year Sharpe Ratio	-0.03	0.28	-0.63	0.68	-0.60	1.22	0.56
1-Year Hit Ratio	44%	43%	43%	36%	23%	100%	47%

Source: Morgan Stanley Research

Exhibit 53: Morgan Stanley Bond Market Indicators - BMI(2) - Performance history

	UST	DBR	UKT	JGB	ACGB	NZGB	CAN
1-Week Return	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
YTD Return	0.1%	-0.8%	-0.7%	-0.5%	0.3%	0.3%	-0.2%
1-Year Return	0.1%	-0.8%	-0.5%	-0.2%	0.4%	0.3%	1.2%
1-Year Return Vol	0.8%	1.3%	1.9%	0.7%	1.5%	1.7%	3.1%
1-Year Sharpe Ratio	0.17	-0.63	-0.25	-0.29	0.29	0.15	0.41
1-Year Hit Ratio	50%	37%	36%	40%	50%	100%	50%

Source: Morgan Stanley Research

Exhibit 54: Morgan Stanley Bond Market Indicators - xBMI - Performance history

	DBR/UKT	DBR/JGB	DBR/UST	UKT/JGB	UKT/UST	JGB/UST
Info ratio	-1.09	0.89	0.04	-0.21	1.95	0.96
Hit ratio	40%	78%	50%	61%	50%	50%
Non-Zero	48%	17%	35%	44%	42%	38%
	ACGB/NZGB	**ACGB/CAN**	**ACGB/UST**	**NZGB/CAN**	**NZGB/UST**	**CAN/UST**
Info ratio	-0.07	1.93	4.90	0.64	1.04	0.95
Hit ratio	41%	78%	69%	57%	75%	33%
Non-Zero	42%	35%	25%	40%	15%	35%

Source: Morgan Stanley Research

Exhibit 55: Morgan Stanley Bond Market Indicators - eBMI - Performance history

	Periphery vs. Core	Semi-Core vs. Core	Periphery vs. Semi-Core
1-Week Return	1.3%	0.1%	0.5%
1-Year Return	5.3%	-6.5%	5.8%
1-Year Return Vol	8.7%	5.0%	6.0%
1-Year Sharpe Ratio	0.61	-1.29	0.96
1-Year Hit Ratio	57.7%	44.2%	55.8%

Source: Morgan Stanley Research

Exhibit 56: Morgan Stanley Bond Market Indicators - iBMI - Performance history

	TIPS	UKTi	HICPxT	JGBi
1-week Return	0.0%	0.2%	-0.1%	0.2%
YTD Return	3.1%	0.6%	0.7%	0.1%
1-year return	5.4%	0.7%	0.6%	1.0%
1-Year Return Vol	2.8%	2.1%	1.6%	1.1%
1-Year Sharpe ratio	1.95	0.32	0.34	0.86
1-Year Hit ratio	61.8%	56.0%	56.0%	52.2%

Source: Morgan Stanley Research

In Case You Missed It

US Public Policy: Tax Reform – Better to Travel than Arrive

30 October 2017

Recent policy optimism helped equities, rates, and USD approach our targets. Yet, the path for tax reform deliberations suggests meaningful stimulus appears unlikely. With scenario-weighted outcomes close to our targets, these markets are approaching levels where tax optimism should be faded.

Global Interest Rate Strategist: America's Next Top Fed Chair Is...

27 October 2017

Investors expect the president to nominate the next Fed Chair in the coming week - a week that couldn't possibly be any busier. The BoJ, Fed, and BoE meet and important data arrive in the US (PCE inflation, ISM, Nonfarm payrolls), the Euro area (CPI, GDP), and the UK (PMI).

ECB Preview: Recalibrating the QE Cutback

23 October 2017

The ECB will likely announce a recalibration of its asset purchases at the upcoming meeting. We've recalibrated our forecast too. The most likely scenario is now a monthly scaleback to €30 billion from January, for nine months.

Global Interest Rate Strategist: Finally Some Fiscal Stimulus?

20 October 2017

Yields rose and curves steepened as US policymakers reignited hopes for fiscal stimulus. We see the steepening as an opportunity to add to strategic curve flatteners. Our Bond Market Indicators remain neutral on duration, given diverse factor signals across the major bond markets.

US Public Policy Brief: Tax Reform & Deficits: Moderate? or Raise the Stakes?

16 October 2017

Will tax reform blow out the deficit? We think not, given Senate constraints & risks to our base case skewed toward legislative failure. Yet while this base case isn't a game-changer, we remain vigilant for certain signposts that, if seen, set up bond market drama: an 'all or none' deficit choice.

Global Interest Rate Strategist: Waiting for Reflation with Flatteners

13 October 2017

ECB Vice President Constâncio said it best: global reflation hasn't happened yet. But better-than-expected growth has kept central banks on the path toward removing extraordinary accommodation. Until reflation actually happens, the removal of accommodation will flatten yield curves.

European Interest Rate Strategist: Push and Pull

6 October 2017

The October ECB is likely to result in lower for longer, while the November MPC is likely to deliver more hikes than previously expected. We like cash over swap in euro, and shift neutral in the UK.

Forecasts

For details on the macro narratives surrounding our forecasts below, please see Global Macro Mid-Year Outlook: Transitioning to Self-Sustaining Growth, June 4, 2017, and Global Strategy Mid-Year Outlook: Climbing the Last Wall of Worry, June 4, 2017. We last updated our forecasts on June 4, 2017.

Exhibit 57: Morgan Stanley sovereign 10-year yield bull, base, and bear case forecasts

	Bull					Base					Bear				
	Nov 2	**3Q17**	**4Q17**	**1Q18**	**2Q18**	**Nov 2**	**3Q17**	**4Q17**	**1Q18**	**2Q18**	**Nov 2**	**3Q17**	**4Q17**	**1Q18**	**2Q18**
US	2.35	2.30	2.20	2.00	1.75	2.35	2.50	2.45	2.45	2.40	2.35	2.80	2.85	2.85	2.95
Germany	0.37	0.20	0.00	-0.30	-0.30	0.37	0.50	0.60	0.70	0.80	0.37	0.70	1.00	1.25	1.50
Japan	0.06	0.03	0.03	0.00	0.03	0.06	0.05	0.08	0.20	0.20	0.06	0.08	0.20	0.25	0.30
UK	1.26	0.80	0.50	0.50	0.50	1.26	1.10	1.00	1.00	0.95	1.26	1.30	1.75	1.90	2.00
Australia	2.65	2.56	2.38	2.09	1.87	2.65	2.75	2.60	2.55	2.45	2.65	2.94	3.00	3.05	3.13
Austria*	17	22	22	25	25	17	27	27	30	30	17	30	32	35	35
Netherlands*	11	15	15	20	25	11	20	20	25	27	11	25	25	30	35
France*	39	40	40	45	50	39	50	50	60	60	39	50	60	75	80
Belgium*	23	30	35	40	45	23	40	45	50	55	23	45	50	60	65
Ireland*	22	50	50	50	55	22	55	55	60	65	22	75	75	90	95
Spain*	112	110	110	125	130	112	120	125	135	140	112	140	150	190	200
Italy*	141	160	165	170	180	141	180	190	205	215	141	195	220	280	290
Portugal*	171	255	250	260	270	171	265	270	280	300	171	290	300	310	330

Source: Morgan Stanley Research
* Yield spread to German Bunds

Exhibit 58: Morgan Stanley sovereign 2-year, 5-year, and 10-year yield base case forecasts

	2Y					5Y					10Y				
	Nov 2	**3Q17**	**4Q17**	**1Q18**	**2Q18**	**Nov 2**	**3Q17**	**4Q17**	**1Q18**	**2Q18**	**Nov 2**	**3Q17**	**4Q17**	**1Q18**	**2Q18**
US	1.61	1.50	1.50	1.60	1.65	2.00	2.05	2.00	2.05	2.05	2.35	2.50	2.45	2.45	2.40
Germany	-0.75	-0.65	-0.60	-0.55	-0.50	-0.35	-0.30	-0.15	-0.05	0.20	0.37	0.50	0.60	0.70	0.80
Japan	-0.16	-0.18	-0.18	-0.10	-0.10	-0.10	-0.13	-0.13	-0.05	-0.05	0.06	0.05	0.08	0.20	0.20
UK	0.41	0.10	0.10	0.10	0.10	0.71	0.45	0.40	0.40	0.35	1.26	1.10	1.00	1.00	0.95
Australia	1.82	1.75	1.70	1.65	1.60	2.18	2.25	2.15	2.10	2.05	2.65	2.75	2.60	2.55	2.45
Austria*	11	12	12	15	15	11	15	15	18	18	17	27	27	30	30
Netherlands*	1	10	10	13	15	-6	5	5	10	12	11	20	20	25	27
France*	16	25	20	25	25	24	30	30	40	40	39	50	50	60	60
Belgium*	12	15	20	20	25	7	20	25	25	30	23	40	45	50	55
Ireland*	18	30	25	30	35	29	30	30	35	40	22	55	55	60	65
Spain*	39	45	50	60	65	55	70	80	90	95	112	120	125	135	140
Italy*	45	60	80	85	85	89	130	145	160	170	141	180	190	205	215
Portugal*	60	80	85	90	100	110	185	175	180	200	171	265	270	280	300

Source: Morgan Stanley Research
* Yield spread to German Bunds

Trade Ideas

Below you will find a list of our current trade ideas, entry levels, entry dates, rationales, and risks.

Duration and Curves

Trade	Entry Level	Entry Date	Rationale	Risks
Long OBL Jul-22 vs BKO Sep-19 and DBR Aug-27 on 2s5s10s fly	-31bp	13-Oct-17	The belly of the curve can continue to outperform as both term premium and rates expectations should stay anchored. The trade carries 7bp/quarter.	US tax reform chances higher than expected and the next Fed chair appointment more hawkish than expected
Long 10y Bund ASW	0.460%	29-Sep-17	QE lasting longer should keep duration and collateral scarcity in the price on Bund vs swap.	The ECB tapers faster than market expected.
Enter 2s30s UST curve flatteners	138bp	15-Sep-17	The hawkish tone regarding the pace of hikes from FOMC members despite the string of disappointing inflation data as well as the lowering of the longer-run dot in the FOMC's SEP supports the flattener.	Progress on the fiscal front above expectations would lead to bear steepening of the yield curve.
Long Jan-45 Jul-65 vs. Dec-55 Gilts	-9bp	6-May-16	Position has positive carry roll and convexity pick-up	Idiosyncratic price action and declining volatility.
Long Jan-60 vs. Dec-55 Gilt	0.4bp	29-May-15	We think the convexity value of ultra longs is underpriced	Idiosyncratic price action and declining volatility.
Receive JPY 20y swap outright (LCH cleared)	0.72%	3-Nov-17	Overseas investors' positioning are skewed to paying side. We would like to fade this move.	Sell-off in overseas rates

Trade	Entry Level	Entry Date	Rationale	Risks
Enter JGB 20s40s flattener	46bp	21-Oct-17	The level looks attractive, and 40y JGB will be supported by lifers on any sell-off.	Banks start to buy 20y JGBs aggressively and dovish person named Fed chair.
Sovereigns and Supply				
Trade	**Entry Level**	**Entry Date**	**Rationale**	**Risks**
Long BTP Aug-22 and SPGB Apr-22 on 30:70 weight vs short FRTR Mar-23 and OBL Oct-22 on 25:75 weight at 66bp	66bp	27-Oct-17	With the tail risk even of eurozone breakup risk further diminished and ECB's easing support for longer, we recommend to long peripheral spreads vs core/semi-core sovereigns.	Widening in peripheral spreads related to political risk in Italy and/or a market getting increasingly concerned about the downside risks to Spanish growth.
Buy RAGB 2117 vs Sell RAGB 2062	30bp	15-Sep-17	Taking forward curve shape and convexity into account, the 100y looks cheap vs the 50y. Moreover, post-syndication price action is generally followed by a richening on the newly issued bond.	50y point of the curve outperforms significantly.
Long BTP Apr-22 vs. short BTP Mar-47	250	1-Sep-17	The curve has already been steepening, which could continue with potential supply pressure. The curve would also continue to steepen if BTP yield sells off further and it carries 11bp/quarter.	Supply remains heavily skewed towards shorter maturity and/or political risk flare up significantly.
Buy Gilt 1.5% 07/2047 at 1.79% and sell Gilt 1.75% 09/2037 at 1.78% vs swaps	30bp/30bp	5-May-17	Relative value trade based on Z-spread/yield to maturity vs duration.	Majority of investors to continue to value the bonds off surrounding maturity issues and other idiosyncratic pricing issues.
Long Low Coupon BTPs vs short High Coupon BTPs portfolio	24bp	3-Feb-17	To protect against rising credit premium in Italy.	Political risk subsides.
Long Nov-47 vs. Dec-46 UKT	-4bp	23-Sep-16	1H47s offer better value due to their longer duration.	Supply optically rich.
Inflation				

Trade	Entry Level	Entry Date	Rationale	Risks
Long 0.625 Jan19s Breakeven	176bp	3-Nov-17	Potential success of a large fiscal stimulus package will likely provide a short-term boost to spending that supports near term CPI prints.	Failure of the fiscal stimulus drive would reduce hopes of a pickup in CPI prints.
Buy Apr20s Breakeven vs Sell Jul19s Breakeven in equal notionals	TBD	3-Nov-17	Potential success of a large fiscal stimulus package will likely provide a short-term boost to spending that supports near term CPI prints.	Failure of the fiscal stimulus drive would reduce hopes of a pickup in CPI prints.
Receive 1y1y US CPI Swap	192bp	20-Oct-17	Potential success of a large fiscal stimulus package will likely provide a short-term boost to spending that supports near term CPI prints.	Failure of the fiscal stimulus drive would reduce hopes of a pickup in CPI prints.
Short OATi Jul-23s vs. OATei Jul-24s real yield	11bp	7-Sep-17	French inflation is much weaker than Euro inflation.	French inflation surprises to the upside.
10s30s HICPxT flattener	44bp	4-Aug-17	10y HICPxT is out of line on the curve.	Non-traditional inflation investors continue to keep 5y5y and 10y down.
Long Nov-47 UKTi vs. Nov-27 UKTi real yield	30bp	7-Jul-17	10y real yields remain rich, while the 30y sector has cheapened into the Nov-56s syndication.	The curve continues to steepen.
Long Apr-20 UKTi breakeven (versus Sep-20s)	289bp	13-Jun-17	Front-end cash breakevens trade fundamentally cheap versus our economists' and the market's pricing of front-end RPI fixings.	Realized inflation comes in much lower than expectations.
Long May-22 BTPei on a real yield basis	0.20%	4-Nov-16	BEIs price in a very subdued inflation outcome, our eBMIs turning more bullish on peripheral risk, carry roll is substantial.	The curve steepens.

3s6s US CPI swap curve steepener	1.75bp	7-Apr-17	We identify value in the CPI swap curve using PCA decomposition.	The 3s6s curve flattens.
10s30s RPI breakeven steepener	-1bp	29-Jul-16	We expect more hedging premium to be priced into the long end.	The curve remains flat.
Buy JGBi21 real yield	-46bp	8-Apr-16	JGB linkers have cheapened well beyond reasonable valuations.	Breakevens breach the deflation floor.
Buy JGBi17 breakeven	10-12bp	6-Mar-16	JGB linkers have cheapened well beyond reasonable valuations .	Breakevens breach the deflation floor.
Long Nov-19 SPGBei breakeven	0.29%	22-Feb-16	We see value in shorter-dated breakevens with at-the-money deflation floors.	Breakevens breach the deflation floor.
Long Apr-20 BTP Italia breakeven	-0.02%	22-Feb-16	We see value in shorter-dated breakevens with at-the-money deflation floors.	Market positioning is long breakevens.

Money Markets

Trade	**Entry Level**	**Entry Date**	**Rationale**	**Risks**
Paying 2y JZ spread on both JSCC and LCH	3bp	27-Oct-17	OIS pricing seems to be too complacent and we expect 3m Libor to pick up from here	Further speculation to the BoJ's early NIRP removal

Short 1y1y FRA-OIS	22.5bp	13-Oct-17	We expect continued AUM flow into MMFs, which is likely to keep FRA-OIS spreads under pressure. Also, the trade rolls positively.	A bank funding crisis would lead to widening of FRA-OIS spreads. A risk-off move would also lead to widening. We recommend maintaining 5y swap spread wideners against the short FRA-OIS position to hedge some of that risk and further improve carry.
Sell 2y swap spreads	26bp	29-Aug-17	The market is not pricing in a sustained increase in T-bill issuance, which should put upward pressure on repo. Also, carry on 2y spread wideners continues to look unattractive relative to history given tight Libor-repo.	A risk-off move or failure by the Treasury to increase T-bill issuance over the medium-term horizon would lead to widening of 2y spreads.
Receive 6m6m USD/JPY Xccy basis	-47bp	9-Aug-17	Increased T-bill issuance and higher repo rates would drain excess reserves in the banking system and reduce access to USD funding by Japanese lifers.	A sharp drop in USDJPY could lead Japanese lifers to reduce their current FX hedges, which would lead to tightening of the Xccy basis.
Tibor-libor 2s10s flattener	0bp	7-Jul-17	Attractive carry and rolldown, and we expect Tibor-libor fixing spread not to tighten after Tibor reform	Tibor lower after Tibor reform; load hedge paying in the long end.
USDJPY basis Rec 7y	-59.5bp	15-Sep-17	Upcoming samurai issuance will likely push the long-end basis lower.	Yankee issuance continues, thereby tightening pressure on the long-end basis.
Receive 5y5y AUDUSD basis	35bp	21-Aug-17	10y point is supported by JGB repackage flow, and it also provides the attractive vol adjusted rolldown.	Reverse Kangaroo issuance increase further.

Derivatives

Trade	**Entry Level**	**Entry Date**	**Rationale**	**Risks**
USD: Long 10y swap spreads	-2bp	3-Nov-17	The November TBAC statement emphasized the preference for short-term UST issuance to fund additional deficit. This is supportive of spreads in the back end. High floater issuance is also likely to keep belly spreads supported.	Heavy issuance in fixed coupon debt could put pressure on belly swap spreads.
USD: Long EDZ7 Call 98.625	0.5c	3-Nov-17	The trade offers an attractive payout ratio of 10x to 20x if the Fed does not hike at the December FOMC meeting.	If the Fed hikes in December, premium on the option is lost.

USD: Buy a 6m10y 2.5% vs 2.65% and 2.80% payer ladder	0c	27-Oct-17	The bearish sentiment in the market and the rise in vol provide a good entry point and an attractive breakeven level at 2.95% for the 10y swap rate.	Appointment of hawkish Fed members or passage of a large stimulus package could lead to the market repricing a higher level of rates than 2.95% on the 10y swap leading to losses on the trade.
USD: Sell Dec18 > 1y ATMF Payer vs Buy Equivalent Caplets	3.5c	27-Oct-17	Expectation of decorrelation in quarterly rates as expectations for hiking steepen or flatten would lead to profit on the trade.	The net premium on the trade would be lost if there is no repricing of the current hiking path.
USD: Sell $1bn 1m2s30s ATM curve straddles vs buy $66.6mm 1m10y ATM straddles	0c	20-Oct-17	The impact of fiscal policy progress on the slope of the yield curve is likely to be offset by hawkish Fed rhetoric, which would anchor the slope of the curve on a terminal basis relative to the level of the 10y swap rate.	Strong receiving demand in the back end by the LDI community could lead to strong flattening of the curve that outpaces the rally in 10y yields.
GBP: Long 3m6m1y 0.65/0.8/0.95 fly	4.5bp	20-Oct-17	We interpret MPC guidance of "gradual and limited" as a pace of one hike every six months (i.e., November 17 and May 18), but then we expect growth to slow further as the UK approaches Brexit, putting rates back on hold until 2H19.	Significantly less dovish/hawkish BOE than market expects.
USD: short FNCL 3s MBS vs rate hedge	100	13-Oct-17	Fed balance sheet unwind would increase the supply of MBS in private hands, which is likely to widen OAS. Maintaining the long vol exposure on the MBS provides potential for further upside if implied and/or realized vol picks up.	If MBS spreads fail to widen and vol fails to increase, the trade loses due to negative carry. It could lose even more if MBS spreads tighten or implied vol on long expiry swaptions drops.
EUR: 3m30y ATMF/+10bp/+17bp payor ladder at zero cost	0c	29-Sep-17	To position for higher rates and contained volatility while benefitting from a reversal in the price action. In addition, the trade rolls down positively.	Substantial sell-off in rates (>27bp) and/or a substantial upward move in implied volatility.
JPY: Rec 3s7s15s fly	-10.825bp	29-Sep-17	Fading the cheapness on the belly of the curve.	The curve massively bull-flattens on the back of an unexpected risk-off scenario.
JPY: 1m20 Bullish Risk Reversal (0.6975% vs 0.8%) at zerocost (LCH ref)	0c	11-Oct-17	Preparing for the post-election unwinding of paying long-end.	The long-end swap paying more on back of further speculation.

AUD: Pay 3y EFP	0.625bp	29-Sep-17	3y EFP have reached historical lows at close to 0. We see little fundamental reason for this being the case, and our tactical framework suggests fading the move tighter.	The trade carries around -3.5bp until December expiry. The negative carry along with a continued sell-off in rates are risks to the trade.
USD: Buy 3m2y payer ATMF in 900mm vs sell 3m30y Payer ATMF +10bp in 100mm	0c	22-Sep-17	The lowering of the long-run FF dot in the FOMC's SEP is likely to lead to a rally in the long end, particularly if inflation data continues to disappoint. Meanwhile, the focus of the Fed on maintaining the pace of hikes as a tool to combat easy financial conditions will lead to flattening of the curve.	Notable improvements in the long-term outlook for inflation and/or growth would lead to bear steepening of the yield curve and losses on the trade.
USD: Buy 3m caplet stuck at 1.5% vs sell caplets struck at 1.55% and 1.6% in 1x1x1 notionals	0.24c	22-Sep-17	The payout ratio if the Fed hikes 25bp in December is 3.5x of premium, which is higher than the payout ratio offered by simply paying the Dec 2017 OIS.	Widening of FRA-OIS spread could lead to losses on the trade, even if the Fed hikes. If the Fed does not hike in December 2017, premium is lost.
USD: Buy 1y7y 2.0% receiver vs sell 1y30y 2.2% receiver in 235mmx100mm	0c	15-Sep-17	Cheapening of vol on 7y tails relative to 30y tails offers an attractive vol pickup relative to recent history.	A large risk-off move in rates could lead to bull flattening of the 7s30s curve leading to losses on the trade.
AUD: Buy 3m1y ATMF receiver vs. sell 2x 3m1y ATMF-7bp receiver vs. buy 3m1y ATMF-14bp	1.4c	15-Sep-17	Our inclination is to extract the re-emerged carry via receiver structures that are protected against sell-offs on a terminal basis.	1y expires above the current 3m1y rate, or below the current 3m1y rate less 14bp, in which case one would lose the premium spent.
RNZD: Rec Feb-18 RBNZ OIS vs. pay 1y1y	61bp	15-Sep-17	The rates market has priced in too much uncertainty relating to the elections, and we think the front end can steepen regardless of whether National or Labour win the election. FRA/OIS seasonally widens out of rolls.	An inconclusive election outcome as well as general risk-off moves (potentially related to increases in geopolitical tensions).
EUR: Long RXZ7 Nov-17 put option at 161.5 vs short RXZ7 Nov-17 at 164.5. for zero cost	0c	7-Sep-17	Valuations are demanding as yields are currently below levels touched when political risk was at its peak early in 2017. Furthermore, the structure expires one day after October ECB meeting, which is when we think it will announce tapering.	Yields continue to fall and/or implied volatility on put collapses, which is likely to happen if expectations for a taper fall to zero and/or economic data deteriorates significantly
JPY: Buy ATM 10y10y Receiver	417bp	1-Sep-17	The rolldown on the trade is positive and a risk-off move is likely to lead to bull flattening of the yield curve and support to 10y10y vol due to Bermudan option vega hedging.	A sell-off in JPY rates associated with selling of vega due to Bermudan book hedging.
AUD: Receive AUD 5y5y vs. USD	82bp	1-Sep-17	Intermediate AU rates have broken out of the range vs. US rates, given strong global and domestic data. The curve should flatten if this dynamic continues, in our view. A positive xBMI signal lends further conviction to tactically fading the move wider.	Positive Australia data and/or the opposite for USD data (in particular US inflation), or a continued outsized widening of AUD FRA/OIS vs. USD.

AUD: Buy AUD 3m10y ATMF receiver vs. sell USD ATMF-1bp receiver for zero cost	0	1-Sep-17	Intermediate AU rates have broken out of the range vs. US rates, given strong global and domestic data. The curve should flatten if this dynamic continues, in our view. A positive xBMI signal lends further conviction to tactically fading the move wider.	Similar to the 5y5y cross-market trade above, with negative P&L if the US rates expires further south vs. the strike than the AUD receiver, in which case losses are theoretically unlimited.
NZD: Receive NZD 5y5y	3.72	11-Aug-17	Upcoming elections, governor change at the RBNZ and the relatively low neutral rate estimates favour long-end received positions. Attractive RV and a moderately bullish BMI signal look tactically favourable.	Risks include a reversal of the recent risk-off move across macro markets, a clear National party win in the election and a stronger than expected 3Q inflation print.
USD: Buy 5.1x 5y1y Receiver ATMF vs sell 1x 5y5y receiver ATMF	31bp	4-Aug-17	The vol on 5y1y is almost the same as that on 5y5y despite 5y1y having higher realized vol. The trade is long vega without much theta decay.	The risk is a continued drop in vol, which would incentivize selling the 5y1y point given the steep expiry curve for 1y tails.
USD: Buy 5y10y ATMF / ATMF-100 receiver spread in 2x notional vs sell a 5y30y ATMF / ATMF -50 receiver spread in 1x notional	205c	14-Jul-17	Longer NC periods on callable issuance will pressure 5y30y vol more than 5y10y, and the trade is long vol at a historically low entry point.	A further drop in vol would lead to losses on the trade. A sell-off in rates would lead to delta losses, so we suggest delta hedging the trade at initiation.
USD: Sell the ATMF stike in a ATMF/ATMF-75/ATMF-125 5y10y receiver fly in 1x/2.45/1x notional	0c	14-Jul-17	The entry point is close to multi-year lows and the trade gets longer vega as rates rally, which is likely to benefit from dealers dVega/dHedging.	A drop in vol is the main risk to the trade.
USD: Buy 9x 6m2s10s cap and 4.6x 6m2y payer vs sell 1x 6m10y payer all struck ATMF	40bp mid	7-Jul-17	Historically cheap entry point and limited downside make the trade a good way to position for decorrelation of 2y and 10y rates.	Premium would be lost if the 2s10s curve rolls to the forward or if rates move significantly without an associated steepening or flattening.
USD: Buy 1y7y receiver fly with strikes 2.5 / 2.0 / 1.6	88c	7-Jul-17	The breakeven range on the 7y rate is approximately 1.65% to 2.42%, which seems pretty wide relative to the realized moves over the past few years.	A large move in 7y rates in 1-year would lead to loss of part or all premium.
GBP: Jun18 Future Call Fly (99.625/99.75/99.875)	2c	16-Jun-17	We think current market pricing for the first hike is exaggerated given the softness of economic fundamentals in the UK and would like to take advantage of it.	The risk of this trade is that BOE hike or cut rates, in which case the premium is lost.
GBP: Jun18 Future Put Ladder (99.625/99.5/99.375)	-1.2c	16-Jun-17	We think current market pricing for the first hike is exaggerated given the softness of economic fundamentals in the UK and would like to take advantage of it but also profit in case of a hike in the next 12 months.	The risk to trade is that BOE hikes more than 2 times in the next 12 months. The potential loss is unlimited.

USD: Buy 1.475x ATMF 2y30y vs sell 1x 5y30y ATMF payers	0c	16-Jun-17	Extension of no-call periods on Formosa callables is likely to increase pressure on the 5y30y point, while owning 2y30y provides upside if vol is bid.	If vol continues to drop, the 2y30y point is likely to suffer more than the 5y30y point given their historical correlation.
USD: Buy 1.4x 6m10s30s vs sell 1x 1y10s30s ATMF curve caps	0bp	9-Jun-17	The 6m/1y 10s30s vol ratio is at the lows, offering an attractive entry point.	If the 10s30s curve steepens but becomes even steeper in forward space, the trade could lose money. Also, if 6m10s30s vol at expiry ends up very high, the trade could lose money.
USD: Buy 1y2y and midcurve 1y2y2y ATMF receivers and sell 1y4y ATMF receiver	3bp	2-Jun-17	As curve correlations approach 1, midcurve vols have cheapened to new lows. This trade presents an attractive risk/reward ratio if the 2s5s curve starts to realize volatility while rolling positively.	A large shift in rates upwards or downwards would lead to loss of premium.
USD: Enter 5y swap spread widener	7.25bp	16-Jun-17	High floater issuance reduces downward pressure on belly swap spreads, and potential for deregulation is a tailwind for across-the-curve spreads.	A major risk event would lead to a widening of front-end spreads and the spread curve could flatten.
USD: Buy 6m30y ATMF USD payors vs 6m10y ATMF+2 payors	0c	24-Mar-17	Shift in focus towards fiscal policy and regulatory reform are likely to increase volatility in long tails more than shorter tails. Ultra-long issuance is a catalyst.	Failure of de-regulation to materialize or the Fed turns dovish, which would reduce the demand on floaters.
EUR: Buy 5y10y ATMF EUR payor vs sell 5y2y ATMF payor at zero cost	0c	10-Mar-17	Attractive forward rate curve and implied volatility rolldown and good performance under gradual policy normalization scenario.	The risk to the trade is that the ECB hikes rates before terminating its quantitative asset purchase programme, leading to a bear flattening of the curve.
Buy $135mm 2y30y at 1927bp versus selling $100mm 5y30y ATM straddles for 2800bp in forward premium	198bp	13-Jan-17	Longer NC periods on callable issuance would pressure the long expiries.	A drop in issuance or failure of reported FSC regulation on NC period minimums to materialize.
Buy AUD 1y3y10y Forward vol	73nvol	12-Dec-16	Expiry curve on 10y tail is sharply downward sloping, providing attractive roll-up.	Vol generally reprices lower and/or expiry curve continues to invert.

Buy 1y2s10s curve cap	137bp	31-Mar-17	Implied correlation exceeds its historical relationship with the curve level, and focus on Fed's balance sheet and ultra-long bond issuance support steeper curves. Also, the trade rolls positively.	If the Fed is priced to hike aggressively, then the 2s10s curve might flatten beyond what's implied by the forward, and premium would be lost.
Buy 3m1s10s curve caps against 3m2s5s caps and 3m10s30s floors	0c	7-Apr-17	Implied realized ratio on 1s10s is favourable compared to the other legs of the trade and the focus on the Fed's balance sheet and ultra-long issuance is likely to steepen the yield curve.	If the market starts pricing in more than 2 hikes in 2018, the 2s5s curve could steepen considerably, and the trade would lose money if 1s10s does not steepen as much.
Buy 1y10y vs 1y2y ATMF vega weighted straddles	1.25 vol ratio	28-Apr-17	Steeper yield curves are likely to lead to outperformance of vol on longer tails.	Aggressive hiking by the Fed would lead to higher realized volatility in the front end, which is supportive of 1y2y vol.
Buy 5y30y Receiver spread ATMF vs ATMF-75bp Receiver	548bp	19-May-17	The rally removed vega from dealers' books, which supports a long vega position.	A significant improvement in economic conditions or issuance of ultra-long bonds could lead to a sell-off in 30y rates and loss of premium on the trade.
Buy 1y1y2y straddle ATMF vs Sell 2y2y straddle ATMF	0c	28-Jul-17	The 1y midcurve vol is trading below 2y vanilla vol and implying a correlation close to 1. The structure is 0 cost and long gamma, while having a superior decay profile to outright gamma trades.	Short-dated vols continue to drop from gamma selling.
Buy JL160 ASW vs 3m libor	2bp	10-Jun-17	Attractive positive carry/rolldown and good support from Japanese banks in 20y JGB.	JGB purchase reduction in long end, banks' loss-cutting of 20y JGBs in any big sell-off.

Exhibit 59: History of recommendations for Euro HICPxT 5y swap breakevens

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
Euro HICPxT 5y swap breakevens	5 year	Long Euro HICPxT 5y breakevens	2-Dec-16	0.0111	27-Jan-17	0.0137				EUSWIT5 Curncy		
Euro HICPxT 5y swap breakevens	5 year	Long 5y short 5y5y HICPxT breakeven curve flattener	27-Jan-17	1.37	3-Mar-17	1.2625				EUSWIT5 Curncy		
EUR Inflation Swap Forward 5Y5Y	5 year	Short 5Y5Y HICPxT (Was: Long 5y short 5y5y HICPxT breakeven curve flattener prior to 3-March)	27-Jan-17	0.017	7-Apr-17	0.0161				FWISEU55 Index		

Source: Morgan Stanley Research

Exhibit 60: History of recommendations for Euro HICPxT 10y swap breakevens

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
Euro HICPxT 5y swap breakevens	5Y	Long 10y on 5s10s15s HICPxT fly	28-Apr-17	1.175	04-Aug-17	1.31				EUSWI5 Curncy		
Euro HICPxT 10y swap breakevens	10Y	Long 10y on 5s10s15s HICPxT fly	28-Apr-17	1.4	04-Aug-17	1.45				EUSWI10 Curncy		
Euro HICPxT 15y swap breakevens	15Y	Long 10y on 5s10s15s HICPxT fly	28-Apr-17	1.617	04-Aug-17	1.63				EUSWI15 Curncy		
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
Euro HICPxT 5y swap breakevens	5Y	Long 10y on 5s10s15s HICPxT fly	28-Apr-17	1.175	04-Aug-17	1.31				EUSWI5 Curncy		
Euro HICPxT 10y swap breakevens	10Y	Long 10y on 5s10s15s HICPxT fly	28-Apr-17	1.4	04-Aug-17	1.45				EUSWI10 Curncy		
Euro HICPxT 15y swap breakevens	15Y	Long 10y on 5s10s15s HICPxT fly	28-Apr-17	1.617	04-Aug-17	1.63				EUSWI15 Curncy		

Source: Morgan Stanley Research

Exhibit 61: History of recommendations for BTP 5s30s steepener

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
BTPS 2.700 03/01/2047	1-Mar-47	Short BTP47s on BTP 27s47s67s fly at 43bp	07-Oct-16	2.47%	27-Jan-17	2.34%				IT0005162828		
BTPS 6.500 11/01/2027	11-Jan-27	Short BTP47s on BTP 27s47s67s fly at 43bp	07-Oct-16	1.52%	27-Jan-17	3.30%				IT0001174611		
BTPS 2.800 03/01/2067	1-Mar-67	Short BTP47s on BTP 27s47s67s fly at 43bp	07-Oct-16	2.93%	27-Jan-17	3.55%				IT0005217390		
BTPS 2.700 03/01/2047	1-Mar-47	Long BTP Mar-47 vs BTP Jun-27 100:75 weighted	23-Jun-17	3.03%	01-Sep-17	3.23%			100	IT0005162828		
BTPS 2.200 06/01/2027	1-Jun-27	Long BTP Mar-47 vs BTP Jun-27 100:75 weighted	23-Jun-17	1.90%	01-Sep-17	2.07%			75	IT0005240830		
BTPS 1.200 04/01/2022	1-Apr-22	Long 5y BTP vs OAT	02-Jun-17	0.92%	01-Sep-17	0.72%				IT0005244782		
FRTR 0.000 05/25/2022	25-May-22	Long 5y BTP vs OAT	02-Jun-17	-0.21%	01-Sep-17	-0.21%				FR0013219177		

Source: Morgan Stanley Research

Exhibit 62: History of recommendations for ATMF+3bp/ATMF+13bp payor spread financed via ATM-17bp receiver for approximately zero cost

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
EUR Swaption 3m30y ATMF payer	7-Dec-17	ATMF+3bp/ATMF+13bp payor spread financed via ATM-17bp	1-Sep-17	49.05	29-Sep-17	46.64				EUNEC30 Curncy		
EUR Swaption 3m30y ATMF payer	7-Dec-17	ATMF+3bp/ATMF+13bp payor spread financed via ATM-17bp	1-Sep-17	49.05	29-Sep-17	46.64				EUNEC30 Curncy		
EUR Swaption 3m30y ATMF - receiver	7-Dec-17	ATMF+3bp/ATMF+13bp payor spread financed via ATM-17bp	1-Sep-17	49.05	29-Sep-17	46.64				EUNEC30 Curncy		

Source: Morgan Stanley Research

Exhibit 63: History of recommendations for Long 10y Bund ASW

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
DBR 0.000 08/15/2026	15-Aug-26	Long German10y	1-Sep-16	-6.60	18-Nov-16	27.00				DE0001102408		
SPGB 1.300 10/31/2026	31-Oct-26	short 10y on Bono-Bund 5s10s30s fly	18-Nov-16	1.588	27-Jan-17	1.58				ES00000128H5		
SPGB 0.750 07/30/2021	30-Jul-21	short 10y on Bono-Bund 5s10s30s fly	18-Nov-16	0.246	27-Jan-17	0.32				ES00000128B8		
SPGB 2.900 10/31/2046	31-Oct-46	short 10y on Bono-Bund 5s10s30s fly	18-Nov-16	2.745	27-Jan-17	2.90				ES00000128C6		
DBR 0.000 08/15/2026	15-Aug-26	short 10y on Bono-Bund 5s10s30s fly	18-Nov-16	0.272	27-Jan-17	0.39				DE0001102408		
OBL 0.000 10/08/2021	8-Oct-21	short 10y on Bono-Bund 5s10s30s fly	18-Nov-16	-0.368	27-Jan-17	-0.37				DE0001141745		
DBR 2.500 08/15/2046	15-Aug-46	short 10y on Bono-Bund 5s10s30s fly	18-Nov-16	0.889	27-Jan-17	1.18				DE0001102341		
FRTR 3.250 05/25/2045	25-May-45	short OAT-Bund 10y20y forward spread	18-Nov-16	1.527	27-Jan-17	2.00				FR0011461037		
FRTR 0.25 11/25/2026	25-Nov-26	short OAT-Bund 10y20y forward spread	18-Nov-16	0.757	27-Jan-17	1.03				FR0013200813		
DBR 0.000 08/15/2026	15-Aug-26	short OAT-Bund 10y20y forward spread	18-Nov-16	0.27	27-Jan-17	0.39				DE0001102408		
DBR 2.500 08/15/2046	15-Aug-46	short OAT-Bund 10y20y forward spread	18-Nov-16	0.895	27-Jan-17	1.18				DE0001102341		

Source: Morgan Stanley Research

Definitions:

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling Protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying Protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

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When more than one issuer or instrument is included in a recommendation, analyst expects one part of the trade to outperform the other trade or combination of other trades included in the recommendation on a relative basis.

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Event Calendar

Exhibit 64: Risk event calendar

Date (GMT)	Time (GMT)	Date (ET)	Time (ET)	Ccy	Event	Ref. Period
06-Nov	07:00	06-Nov	02:00	EUR	German Factory Orders (MoM)	Sep
	08:15		03:15	EUR	Spanish PMI Services	Oct
	08:45		03:45	EUR	Italian PMI Services	Oct
	08:45		03:45	EUR	Italian PMI Composite	Oct
	08:50		03:50	EUR	French PMI Services	Oct F
	08:55		03:55	EUR	German PMI Services	Oct F
	09:00		04:00	EUR	PMI Services	Oct F
	09:00		04:00	EUR	PMI Composite	Oct F
	10:00		05:00	EUR	PPI (YoY)	Sep
	15:00		10:00	CAD	Ivey PMI	Oct
	17:00		12:00	USD	Fed's Dudley (voter) spks (Lessons from Financial Crisis)	
	22:30		17:30	AUD	Consumer Confidence	
07-Nov	00:00		19:00	JPY	Labor Cash Earnings (YoY)	Sep
	00:01		19:01	GBP	BRC Sales Like-For-Like YoY	Oct
	03:30		22:30	AUD	RBA Rates Decision	
	05:30	07-Nov	00:30	AUD	Foreign Reserves	Oct
	07:00		02:00	EUR	German Industrial Production (MoM)	Sep
	08:30		03:30	GBP	Halifax House Prices (MoM)	Oct
	09:00		04:00	EUR	Italian Retail Sales (MoM)	Sep
	10:00		05:00	EUR	Retail Sales (MoM)	Sep
	15:00		10:00	USD	JOLTs Job Openings	Sep
	17:35		12:35	USD	Fed's Quarles (voter) spks (Clearing House Conference)	
	17:45		12:45	CAD	BoC's Poloz spks (Montreal Council on Foreign Relations)	
	19:00		14:00	CAD	BoC's Poloz spks (Press Conference)	
	20:00		15:00	USD	Consumer Credit	Sep
	N/A		N/A	USD	US President Trump Visits S. Korea	
08-Nov	N/A	08-Nov	N/A	CNY	Trade Balance	Oct
	N/A		N/A	CNY	Exports (YoY)	Oct
	N/A		N/A	CNY	Imports (YoY)	Oct
	05:00		00:00	JPY	BoJ's Funo spks (Press Conference)	
	05:00		00:00	JPY	Leading Index CI	Sep P
	05:00		00:00	JPY	Coincident Index	Sep P
	07:45		02:45	EUR	French Trade Balance	Sep
	08:00		03:00	EUR	Spanish Industrial Production (YoY)	Sep
	08:00		03:00	EUR	Spain Industrial Production (MoM)	Sep
	13:15		08:15	CAD	Housing Starts	Oct
	15:30		10:30	USD	EIA Crude Oil Inventories	
	20:00		15:00	NZD	RBNZ Rates Decision	
	20:00		15:00	NZD	RBNZ Monetary Policy Statement	

Source: Morgan Stanley Research, Bloomberg

Ratings

Exhibit 65: Sovereign Bond Ratings

		Aaa/ AAA	Aa1/ AA+	Aa2/ AA	Aa3/ AA-	A1/ A+	A2/ A	A3/ A-	Baa1/ BBB+	Baa2/ BBB	Baa3/ BBB-	Ba1/ BB+	Ba2/ BB	Ba3/ BB-	B1/ B+	B2/ B	B3/ B-	Below B3/ B-
US	Moody	STA																
	S&P		STA															
	Fitch	STA																
JPN	Moody					STA												
	S&P					STA												
	Fitch						STA											
UK	Moody			STA														
	S&P			NEG														
	Fitch			NEG														
GER	Moody	STA																
	S&P	STA																
	Fitch	STA																
FRA	Moody			STA														
	S&P			STA														
	Fitch			STA														
AUT	Moody		STA															
	S&P		STA															
	Fitch		STA															
NETH	Moody	STA																
	S&P	STA																
	Fitch	STA																
FIN	Moody		STA															
	S&P		STA															
	Fitch		STA															
BEL	Moody				STA													
	S&P			STA														
	Fitch				STA													
SPA	Moody									STA								
	S&P								STA									
	Fitch								POS									
ITA	Moody									NEG								
	S&P									STA								
	Fitch									STA								
IRE	Moody						STA											
	S&P					STA												
	Fitch						STA											
POR	Moody											POS						
	S&P										STA							
	Fitch											STA						
GRE	Moody																	POS
	S&P																STA	
	Fitch																	POS

Source: Morgan Stanley Research, Moody's, Standard and Poor, Fitch
STA: Outlook Stable, NEG: Outlook Negative, DEV: Outlook Developing, OW-: On Watch Negative, POS: Outlook Positive, SD: Selective Default

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Equal-weight/Hold	**1413**	**44%**	**359**	**48%**	**25%**	**682**	**46%**
Not-Rated/Hold	**56**	**2%**	**6**	**1%**	**11%**	**9**	**1%**
Underweight/Sell	**606**	**19%**	**92**	**12%**	**15%**	**237**	**16%**
TOTAL	**3,229**		**750**			**1490**	

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